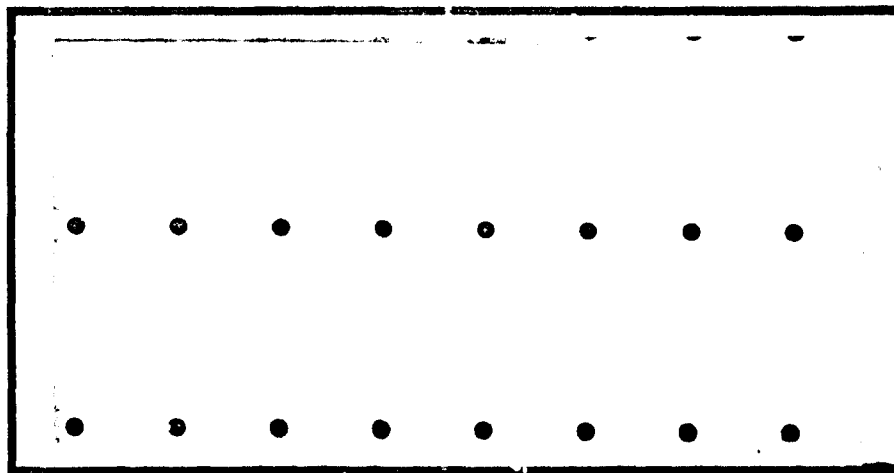


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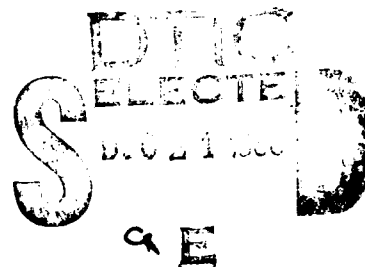
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AN EXAMINATION OF THREE FORMS OF
PRIVATE SECTOR FINANCING OF
MILITARY FACILITIES

THESIS

Christopher R. King
Captain, USAF

AFIT/GSM/LSY/88S-13



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AN EXAMINATION OF THREE FORMS OF PRIVATE SECTOR
FINANCING OF MILITARY FACILITIES

THESIS

Presented to the Faculty of the School of Systems and Logistics
of the Air Force Institute of Technology

Air University

In Partial Fulfillment of the
Requirements for the Degree of
Master of Science in Systems Management

Christopher King, B.S.C.E.

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September 1988

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Preface

The purpose of this study was to examine three statutes in the United States Code pertaining to Private Sector Financing (PSF) of military facilities. The main objective was to identify legal questions and issues which project officers will face in developing a facility using PSF. Answers to these questions are researched and presented in a table to assist those working PSF facility projects.

In performing this research and writing this thesis, I received a great deal of help. I am deeply indebted to my thesis advisor, Lt. Col. Jeffrey Phillips for his continuing support and encouragement. I also wish to thank my proof reader, Capt. Mark Cercise and my typist, Mrs. Pat Norton. And last, but certainly not least, I express my deepest appreciation to my wife for her cooperation and patience over these sixteen months.

Christopher R. King

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Abstract

The purpose of this study was to introduce the concept of Private Sector Financing (PSF) of military facilities instead of acquiring facilities via the Military Construction Process. Another goal ~~of the research~~ was to provide project officers with answers to questions which will arise in the development of a PSF project. Specifically, this study examined three avenues of PSF presently authorized by Congressional law. These answers are presented in a quick reference guide, which was developed after an indepth analysis of the U.S. Statutes and interviews of those involved with PSF in the Department of Defense. Additionally, this research presents conclusions from military PSF projects to date and recommendations for future projects.

AN EXAMINATION OF THREE FORMS OF PRIVATE SECTOR FINANCING OF MILITARY FACILITIES

I: Introduction

Chapter Overview

This chapter first identifies the facility construction needs within the Department of Defense (DOD), problems associated with the DOD's present facilities acquisition process, the future facility budget challenges, and introduces a new concept for acquiring DOD facilities and services. Secondly, this chapter explains the specific purpose and justification for this research, followed by a list of research objectives and questions. Finally, this chapter discusses the scope and limitations of this research effort.

Need

The need for new DOD facilities exists in part to replace aging facilities. A 1985 study of naval shore facilities determined the average age of a Navy facility is over 40 years (20:3). Similarly, the Air Force facility age is exemplified in the following quote:

When Orville Wright dedicated Wright Field in 1927, he couldn't have imagined that sixty years later the architects of the 21st century Air Force would be forced to develop tomorrow's

revolutionary flying systems in the same buildings he saw on that gray October day [1:2].

The DOD's present replacement rate is one percent per year (80). At this rate, our facilities will need to last 100 years each (80). Additionally, new facilities are needed to support specialized security requirements, to allow for centralized location of workers, and to improve the quality of the working environment (1:1). The DOD's need for new facilities, from visiting quarters to energy cogeneration plants, stems from not only a physical but also an economic need. Many potential facility investments can provide a positive return on the investment by reducing future years' expenditures in everything from hotel bills to utility bills (40; 61). Often these projects show great economic viability but never receive funding since they must compete for funds with other projects with higher mission priorities (20:2). For these reasons, the United States Air Force (USAF) is facing an increasing need for facilities.

Outside of a situation of national security, the only DOD process for acquiring new facilities valued at more than one million dollars is the Military Construction Project (MCP) process (68:153). An MCP is defined in the Military Construction Codification Act of 1982 as "all construction, development, or conversion necessary to produce a complete and usable facility with respect to a military installation" (68:153). However, problems exist with this MCP process.

Problems with the MCP Process

Three major problems with the MCP process are long response times, high construction costs, and the federal budget. The fastest possible schedule for an MCP is five years, and the majority take much longer (34:10). To fully understand why the MCP process takes so long, the MCP process needs to be examined.

The basic steps the USAF follows in the acquisition of new facilities are similar to that found in the private sector. First, the requirement or need for a new facility must be identified (34:20). Second, a facility program or plan must be written accessing the functions of the facility (34:22). Third, an architectural and engineering (A&E) firm develops the program into a design (34:23). The A&E then transforms the design into construction drawings and specifications (34:24). The fourth step involves hiring a construction company to build the facility in accordance with the plans and specifications. The four basic steps are the same for both military and private-sector projects. Military projects though, involve many time consuming checks and balances to insure the proper expenditure of public monies. The result being a building using MCP takes several years longer to complete than the same building if built in the private sector (13:58; 34:19). Closer examination of these four basic steps reveals why the military process is so lengthy.

Requirements identification, or realizing the need for a new facility is the first step. The time required for this step is viewed as the same for the government or the private sector.

The second step involves recording the new facility's requirements in a programming document called the Military Construction Project Data or simply a form DD 1391 (34:22). The Military Construction Project Data briefly describes the proposed construction, includes a cost estimate, and a justification for the project (34:22). Upon completion of the military construction project data, the deployment base submits it to their major command. The major command reviews the MCP data and prioritizes this project with respect to all of the other needed projects within the command. Next, the major command submits their prioritized list to the Headquarters USAF programming division (34:22). Headquarters USAF prioritizes all the facility needs of the USAF. Assuming this project is a priority and sufficient funding exists, Headquarters USAF issues instructions to one of the five Air Force Regional Civil Engineers (AFRCE) to put the physical design of the facility into action (34:22). In the private sector, the economic merits of the project would be evaluated after an A&E developed a conceptual design and preliminary cost estimate. Should the new facility prove to be cost effective, the private entrepreneur secures financing and initiates the full design process with an A&E firm.

The third step, the design, is the actual preparation of plans and specifications necessary for constructing the project. Typically, the AFRCE turns the design responsibility over to either the Army Corps of Engineers (COE) or the Naval Facilities Engineering Command (34:23). According to Steve Fleener, Director of the Air Force Branch of the Army Corps of Engineers' Construction Division, the COE contracts out approximately 85 percent of their design work to the private sector (21). Thus, the majority of the time, COE hires a civilian A&E firm in accordance with the Federal Acquisition Regulation (FAR) (21). The FAR details the government's A&E selection process, which gives great consideration to providing work to small business, minority-owned firms, and insures an equitable distribution of contracts among the local A&E firms. Upon selection of the A&E firm, instructions to develop the project's design to a 35 percent completion point are issued (34:22). The 35 percent project status and a revised cost estimate are submitted to Congress in January of each calendar year (34:23). Congress reviews and typically authorizes construction funding in late September of that year (34:23). A construction project receives its final approval when the President signs the Military Construction Appropriation Bill into law (34:23). There is no guarantee Congress will approve a particular project. Congress has eliminated a seemingly solid and valid project, just to insert another project (40). Between January and September, the A&E firm completes the design, construction

drawings and specifications, all governmental groups approve the design (34:24). A few of the governmental groups required to approve a typical A&E's design need to be listed to show the reader how many agencies are involved. A typical approval list includes: the user of the proposed project; the base civil engineering group where the project is located; the major command's civil engineering staff; the AFRCE; and finally, the Army Corps of Engineers. If the project's design is not completed and approved by all parties before the Congressional review, the project may be rejected and must wait until the next calendar year (34:24). In the private sector, the entrepreneur selects an A&E firm and design commences without redundant agents or Congress' rigid approval calendar.

The last step, construction, starts after the selection of a contractor. A formal selection process is strictly regulated by public laws and some jobs are set aside for minority and small business contractors. Once the construction contract is awarded to the lowest qualified bidder, the contractor commences construction under a supervision of the government construction agent (34:24). Barring labor strikes, material shortages, or major design changes, the contractor completes construction of the facility.

While the four steps to complete construction of a facility are basically the same for the Air Force and the private sector, the Air Force process takes longer (13:57). An old adage, "time is money," applies to the Air Force's

MCP process. The higher number of players in each project phase serves to drive the USAF's costs up over the entrepreneur's. Other public laws also serve to increase the government's costs.

The higher costs associated with DOD construction projects stem from two major reasons. These reasons are the cost of USAF's design and construction management agents and the prevailing wage laws required by the Davis-Bacon Wage Law. These costs are quantified in the literature and in government regulations.

By law and with only rare exception, the USAF employs either the Army Corps of Engineers or the Naval Facilities Engineering Command as their construction management agents (21; 37). In the majority of cases, the sister organizations do not perform the actual work, but instead hire civilian A&E firms and construction contractors (21). The sister organization is compensated for the actual cost of the A&Es and contractors, along with the cost of their government employees, who manage and review the projects (21; 37). In 1987, on a typical project, the COE charged the USAF an average of 2.3 percent of the estimated construction cost for administering the design phase (37). This is over and above the maximum of 6 percent of the estimated construction cost paid to the A&E firm for designing the project (37). Next, the COE is paid 5½ percent of the estimated construction cost to oversee and inspect the construction contractor's work (55). Adding these

percentages up shows the USAF often pays 13.8 percent over the actual construction cost for design, inspection, and construction management. In the private sector, the owner typically pays between 2.5 to 10 percent for both design and inspection (80). These are not the only factors increasing costs over the private sector.

The second reason causing the government construction costs to be higher is the Davis-Bacon Wage Act (8:170; 63:127). This Congressional act sets minimum wage standard for workers who are employed by private contractors or subcontractors on federal construction projects (8:6). In abridged form the law reads:

The advertised specifications for every contract in excess of \$2000 to which the United States . . . is a party, for construction, alteration, and/or repair, . . . of public buildings or public works of the United States . . . and which requires or involves the employment of mechanics and/or laborers which shall be based upon the wages that will be determined by the Secretary of Labor to be prevailing for the corresponding classes of laborers . . . employed on projects of a character similar to the contract work in the city, . . . in which the work is to be performed [69:521].

The law was enacted

to protect local wage standards by preventing contractors from basing their bids on wages lower than those prevailing in the area, and to give local labor and local contractors fair opportunity to participate in the building program [69:526].

The law also states that it "was passed for benefits of employees, not contractors, and served only to establish a

floor for payment of wages and benefits" (69:526). Taxpayers do not benefit from this law as it increases the cost of government construction (63:119). The most reputable studies place the increased total construction cost in the federal sector by 5.6 percent (63:108). Today, using even the most conservative of estimates, Davis-Bacon results annually in increased construction costs exceeding one billion dollars (63:113).

While the facility needs of the Air Force are growing in both quantity and cost, our nation is fast approaching an era of fiscal limits (87:5).

Future Budget Challenges

In recent years one of the taxpayers largest concerns is the federal budget. With the advent of the Balanced Budget Act of 1985 (Gramm-Rudman-Hollins (GRH)), Congress must end deficit spending (87:1). Quite simply, Congress must either spend less or take in more taxes. Taxpayers have revolted against more taxes through measures like California's Propositions 13 and 9 (46:1). Consequently, with tax increases politically unpopular, politicians may choose to curb federal spending, of which the defense budget is a major component. In 1988, this initial spending reduction resulted in the DOD's budget falling short of the funding requested by the Pentagon (57:1-F). According to the New York Times Services, "The issue facing the next president - and Congress and the Military - is no longer whether

military programs must be reduced, but how much and where" (57:1F).

One program of the defense budget, Military Construction (MILCON), can expect to be reduced as the DOD struggles in the coming austere budget years (40; 80; 87:1). Even with the largest MCP budgets in recent years, many projects which could provide a positive return on investment by reducing annual maintenance cost have not been funded (20:2). It is not uncommon for savings to results from construction of a new facility which are of sufficient magnitude and duration to offset the project's construction cost (20:2). If these projects which could provide a return on investment were not funded in plentiful MILCON years, balanced budget years will guarantee these projects are never funded. This is not a new problem.

About a decade ago, Congress began looking for creative ways to fund large, expensive, near-term projects without large, upfront outlays and provide for long-term contracts (up to 30 years) to expense them [87:1].

Long-term contracting or leasing provides the government a way to fund expensive construction projects by expensing them over twenty or more years while not increasing the federal budget (42; 87:2). The idea works with the government contracting with an entrepreneur to build a facility and either leasing or making installment payments to use the facility (42; 86:1).

The private sector can often perform at less cost than the government (28:85). The President's Blue Ribbon Commission on Defense Management stated the following as one of its recommendations:

No matter how the DOD improves its organization or procedures, the defense acquisition system is unlikely to manufacture products as cheaply as the commercial marketplace. DOD cannot duplicate the economies of scale possible in products serving a mass market, nor the power of the free market system to select and perpetuate the most innovative and efficient producers. Products developed uniquely for military use and to military specifications generally cost substantially more than their commercial counterparts [50:23].

The concept of public/private venture programs offers a solution to unfunded facility requirements.

Private-Sector Financing

Private-Sector Financing (PSF) is an alternative avenue for the Air Force to construct facilities. PSF involves attracting capital from the private sector to finance, design, build, operate, and maintain a facility for the government (2:6-2; 86:1). In turn, the government provides a market and often the land for the facility (2:1-1; 86:2). Already, Congress has passed several public laws allowing various PSF projects in the United States (U.S.). Before this topic can be examined, several definitions must be provided.

Definitions.

1. Alternative Financing - Financing for projects other than through standard government means (2:G-1).
2. Cogeneration - The production of two or more forms of energy, typically electricity and steam from a single fuel source (6:51).
3. Contracting Out - A government entity contacting with a private company to provide public goods and services (45:11).
4. Facility Capital - An entrepreneur's design and construction costs of facilities and equipment which are not "written off" in the tax year such costs are incurred, but depreciated over the facility's life cycle (17:2).
5. First Money - the risk capital personally (or internally) supplied by the entrepreneur (17:2).
6. In-Leasing - Government acquisition of land or buildings, not previously owned by the government through a lease (2:G-1).
7. Lease - Any agreement which gives rise to relationship of landlord and tenant (9:1035). Conveyance or grant of estate in real property for limited term with conditions attached (9:1035).
8. License - Permission or authority to do particular act or series of acts on land of another without possessing any estate or interests therein (9:1068).
9. Outleasing - The leasing of government-owned land to a private entity (2:G-2).

10. Outlay - "The actual amount of dollars spent for a particular activity. It is the level of outlays compared to the level of revenues that determine whether the budget is in surplus or deficit" (12:186).

11. Privatization - The process where the private sector provides capital, goods, and services to the public sector which traditionally are provided by government. It is the "umbrella" term used to describe private-sector contracting, leasing, third party financing, alternative financing, acquisition strategy, shared savings, etc. (2:G-2).

12. Third Party Financing - An arrangement in which a facility is built for a group by a contractor, who obtains long-term financing for his effort from a third party (2:G-3).

13. Triple Net Lease - A lease arrangement where the lessee or tenant pays rent sufficient to cover the lessor's or landlord's fixed costs and provides the landlord a profit. Additionally, the tenant pays directly all variable costs such as maintenance, utilities, and taxes (79:168).

14. Turnkey - a single contractor designs and constructs a complete construction project (65:1).

15. Venture Capital - The risk capital externally supplied by outside nonassociated sources (17:2).

Privatization of the Government

The validity of privatization of government is exemplified by the following quote by Adam Smith:

Public services are never better performed than when their reward comes only in consequence of their being performed, and is proportional to the diligence employed in performing them [28:26].

Bureaucrats, like their counterparts in the private sector, seek to be more efficient when a high correlation between effort and reward exists (28:26). The private enterprise manager is rewarded for saving money. Should a bureaucrat not spend his entire budget, his reward is a drop in status through a reduction in his following year's budget (28:28). Even a conscientious bureaucrat, working for the best public good, will want to achieve personal goals such as status, income, and promotion (28:29). Ironically, these goals are often obtained by an enlargement of agencies, budgets, and employees (28:29). Turning to the private sector as a source of public goods, is a possible method to reduce the cost of government.

History of Privatization in the U.S. To best understand the future of PSF, one needs to look at the evolution of privatization within the government. For over three decades the government has contracted out services under OMB circular policy A-76 to reduce costs (29:6). Recently, President Reagan created the Privatization Council, a nonprofit organization comprised of members from

the public and private sectors, to further the concept and practice of privatization (49:2). Many of the benefits of privatization can be realized in a construction project using private-sector financing (PSF). An initial examination of privatization shows what can be gained through PSF.

The use of the private sector, by the federal government for goods and services is not a totally new concept. Back in 1955, President Eisenhower stated:

It is the general policy of the administration that the Federal Government will not carry on any commercial activity to provide a service or product for its own use if such product or service can be procured from private enterprise through ordinary business channels [29:6].

Later in the Eisenhower Administration, the Bureau of the Budget issued Circular No. A-76 (29:7). The theory that private enterprise can produce goods more efficiently is supported by the fact that competition pushes progress (29:4). The rationale for privatization and PSF is summarized in the following:

Often small private companies are able to perform at a lower cost because they are competitive, operate more efficiently, are free from bureaucratic obstacles and can more easily adjust employment levels [48:48].

A 1984 study by the Logistics Management Institute examined DOD A-76 contracts to identify the steps private contractors take to minimize costs over the previous government operations (62:48). These steps included the following:

Organizational changes;
Consolidation of working areas;
Use of working supervisors;
Use of multi-skilled workers;
Use of lower-skilled workers;
Provision of equipment, vehicles and communications;
Establishment of worker goals and accountability;
Provision of computer support;
Elimination of unnecessary work (62:48).

These same approaches which contractors use on A-76 contracts are applicable to PSF contracts. The most impressive A-76 results were reported in a Rand Corporation study of Vance AFB, Oklahoma, and Reese AFB, Texas (45:39). Both bases are of similar size and output, but differ in that Vance AFB is completely contractor operated (45:39).

The findings were that 26 percent fewer people at 87 percent of the cost were used at Vance to accomplish approximately the same mission under the same circumstances than at Reese [45:39].

Realistically, the same efficiencies could apply to the construction and operation of a facility by an entrepreneur.

Other empirical evidence, primarily in two summaries of the literature, supports the practical success of privatization. One major study, "Comparing the Efficiency of Private and Public Production: The Evidence from Five Countries" published in the Journal of Economics in 1982, compared the cost of public versus private operations (28:96). The study examined results and findings from over 50 other studies covering nineteen various public activities (28:84). The findings were that the vast majority, 42 to be exact were "consistent with the notion that public firms

have higher unit cost structures" (28:84). Another study, "Tax Reduction without Sacrifice: Private-Sector Production of Public Services" which appeared in the Public Finance Quarterly of October, 1982, concluded that "the evidence was generally in favor of significant cost reductions through privatization" (28:85). Both studies concluded that "private production is cheaper than the production in publicly owned and managed firms" (28:85).

The A-76 policy is criticized as not working and ultimately costing the taxpayers more in the long run. In 1983, Congress requested the General Accounting Office (GAO) to investigate this claim (24:1). The GAO judgmentally selected 20 DOD functions that were converted to contractor operations to determine if savings were actually being realized by the government (24:1). The results were that 17 were providing savings, two were costing more, and one was undeterminable (24:1). The GAO found the major problems with these contracts to be errors and ambiguities in the statements of work (24:1). The statements of work were inadequately prepared by the government (24:3). Also, four of the 20 contracts examined, had to be recompeted because of poor performance by the initial contractor (24:5). These findings can serve as lessons to government officials preparing PSF contracts.

President Reagan, by Executive Order 12607 of September, 1987, created a 13-member bipartisan council to study all federal programs and activities that could effectively

be turned over to the private sector (52:1). The council recognized that our government must be responsive to the ever changing environment and not held captive in its inflexible ideologies and procedures (48:xi). In the council's report to the President they summed up why concepts like PSF must be examined.

The American people have often complained of the intrusiveness of federal programs, of inadequate performance, and of excessive expenditures. In light of these public concerns, government should consider turning to the creative talents and ingenuity in the private sector to provide, wherever possible and appropriate, better answers to present and future challenges [48:xi].

The commission's positive report on privatization along with the government's growing needs in the face of future austere budget years, will increase the interest in PSF of facilities.

While great similarities exist between A-76 contracting and the wide range of potential PSF approaches, the differences need to be identified. An A-76 contract typically is for operation of a labor intensive function and often uses government furnished equipment and facilities. With a PSF contract the contractor not only operates but, provides the equipment and facilities. Additionally, due to the PSF contractor's large upfront capital investment, the term of the contract is for a substantially longer term, 20 years, where an A-76 agreement is only three years (2:1-4). While these differences exist, the facts remain that the USAF can

turn to the creative talents and ingenuity in the private sector to improve efficiency (48:xi).

Conditions Required for PSF. According to a handbook by Robert Stone, the Deputy Assistant Secretary of Defense for Installations, four factors must exist for a successful PSF venture (60:7). In Secretary Stone's Winning with Other People's Money, the first factor is a valid need (60:7). The second factor, land, either government or private must be available for the project. Third factor, community support, not opposition, must exist behind the PSF project (60:7). The fourth factor, the private-sector must be interested in the PSF project (60:7). Private-sector interest is provided by a profit potential of such a venture (60:8).

History of PSF. Tracking the history of PSF, in both the private sector and the DOD provides some clue as to how this concept can be used. A similar concept to PSF, third party financing is used in the private sector and is gaining popularity. While in the military, history shows the DOD used PSF as early as 1897 (75:635). At many overseas bases, the DOD leases facilities from foreign contractors because the U.S. may be unable to acquire property (7). The DOD is already involved in a number of PSF projects through out the U.S. (7). Numerous PSF projects are providing military family housing throughout the U.S. (13:57). New legislation is being passed by Congress to further test this innovative concept.

In the private sector, corporations often realize an investment in a new facility can benefit them. But, they may not want to bear the upfront capital costs. In this situation, a growing number of companies are turning to third-party deals to capitalize on a variety of economic opportunities (6:51).

One interesting example involves the Great Lakes Carbon Corporation putting the waste heat generated by it's plant to productive use through cogeneration (6:51). The Great Lakes Carbon Corporation contracted out the construction and operation of a cogeneration plant with Power Systems Engineering, a third-party financier and developer (6:57). While the Great Lakes Carbon Corporation guaranteed to provide their waste heat and the land for the plant, they in return received 25 percent to 60 percent of the plant's revenue (6:51). This revenue comes without investment or risk.

Fire departments are typically thought of as one public service which must be provided by the public sector. Yet, many American cities have turned to the private sector for this service. The largest city to date, Scottsdale, Arizona, is also the city with the oldest history of a completely contracted fire department, since 1952 (28:148). Scottsdale residents are charged just 48 percent of the national average for fire protection in a city their size (28:148).

A study by the Institute for Local Self-Government found that in a comparison with nearby cities using government fire services, Scottsdale had a faster response time, comparable insurance rating and comparable average annual fire loss [28:148].

With tight public budgets more cities will be looking toward the private sector for fire protection (28:148).

Another example of both PSF and Privatization appeared in the June, 1988, issue of Inc. Magazine. The article examined the Corrections Corporation of America (CCA), who build, manage, and maintain public prisons for profit (33:87). To date, their market has been in the southern states and primarily consists of county correctional facilities (33:88). This operation has performed amazingly well. The Bay County, Florida, emergency-management director, Larry Davis, commented on the sleek and modern jail constructed by CCA for his county. He stated, "They had it planned, built and occupied in six months. We can't find an architect in six months" (33:90). Before CCA took over, the Bay County Jail and the County Commissioners had been sued repeatedly (Inc.:90). CCA was so confident in their performance, that in their contract, they promised to represent the government agency in the event of any lawsuit and pay any awards made against the county (33:87). CCA claims the key to their success is their freedom from bureaucratic restraints and red tape (33:88). They act faster in everything from construction to buying shampoo (33:88). Other keys to CCA's success are employee incentives and their

ability to design more efficient, less labor-intensive jails (33:88). Similar applications such as these can be utilized by the DOD.

Alternative forms of private-sector financing for DOD facilities date all the way back to the 1800's. One of the first examples of PSF was in 1897 when land was granted by the Secretary of War to a Roman Catholic Archbishop to erect and maintain a chapel at West Point (75:635). A more recent example of PSF was the Armed Services Housing Mortgage Insurance Act of 1949 (42; 53). The purpose of this act was to provide low-cost military housing adjacent to military bases through a cooperative effort of government and private business (42; 53). One of the many products of this act is Page Manor Family Housing located on Wright-Patterson AFB, Ohio. While these projects set a historical precedence, PSF to date, has not received a lot of attention in the military.

Another area where PSF is not new is the leasing of facilities overseas. Deviation from the standard MCP process is often required due to two factors other than economic, often faced in foreign nations (43). In some situations the U.S. does not have room for the needed facility at an existing base and must turn to the local community (40). The military may find the acquisition of land in a foreign country far more complex than in the U.S. (40). In some nations purchase of land by the U.S. is virtually impossible. Additionally, the Status of Forces Agreement or the Defense Cooperative Agreement which are

negotiated by the State Department might require the U.S. use PSF for their facility needs (2:5-15). In some situations the host government is the private-sector entrepreneur building and leasing the facility to the U.S. (2:5-15). Several successful PSF projects have developed this innovative concept.

Two recently completed PSF projects in Europe show how the build/lease concept can work. At Spangdahlem AB, Germany, the Air Force entered a build/lease agreement for a 56-unit temporary facility (TLF) located off the base (2:7-6). The entrepreneur, as a condition of the initial five-year lease, designed, constructed, financed, and operates the facility to meet the Air Force's needs (2:7-6). Another PSF project using the build/lease concept is a military family housing (MFH) project of 460 units near Comiso AFB, Italy (2:7-11). Again, the Air Force turned to the foreign private sector to satisfy the Air Force's need for both land and facilities (2:7-11). The use of PSF is not limited to overseas projects, but is also used in the U.S.

Within the U.S., the DOD's PSF experience is limited to a few completed projects and several proposals for large facilities. The PSF experience base is growing simultaneously in all three military services (23; 37; 40; 80). Each service has established a special program office to further the development of PSF and assist individual bases in the use of PSF on selected candidate projects.

On Goodfellow AFB, Texas, the Air Force has a 20-year contract to lease 200 military family housing (MFH) units from a local entrepreneur (2:5-15). The Army uses PSF so extensively in developing a new, light infantry base at Ft. Drum, New York, that many refer to the project to build this fort as a "Rent-a-Fort" (42). At Fort Drum the MFH was provided by a private developer (18; 22). For Drum's temporary lodging facilities are being provided by a subsidiary corporation of Holiday Inns of America (27). Also, the wastewater treatment plant for the fort and the surrounding county is under contract to a private entrepreneur (42).

Two proposed PSF projects, receiving a lot of attention, are located at Wright-Patterson AFB, Ohio. The first one, a 250-room hotel and conference center to be located on the base is currently in source selection (84). The successful bidder will design, finance, build, and operate the hotel for 40 years. In this project the military does not guarantee any payments to the hotel owner (35; 84). Compensation for the entrepreneur's investment is paid by each military traveler using the hotel or conference facility (25). The military traveler then claims the cost of hotel on his travel voucher (40). This approach allows the Air Force to compensate the entrepreneur for the cost of the facility by expensing their travel budget (40). Another proposed project at Wright-Patterson AFB, a new 760,000 square foot complex for Aeronautical Systems Division (ASD)

shall be designed, built, and financed by an entrepreneur (1:6; 56). The contractor would lease to the Air Force a state-of-the-art facility, customized for ASD (1:6; 56). If successful, this 200 million dollar project would be the largest PSF project to date (56). Additionally, the demand for information about PSF would increase as more managers view this process as a mechanism to solve their facility needs. Unfortunately, the Air Force's limited knowledge of PSF hinders widespread use of this concept (40:28).

Statement of Problem

The purpose of this research is to investigate and provide a starting point for an individual to gain knowledge about the PSF avenues available. Since no formal regulations exist on the topic, the public laws which control the DOD's current use of PSF must be examined. In the preparation of a statement of work, various unresolved legal issues with PSF will arise. Since a precedence will be provided by the initial PSF projects, an effort should be made to develop a sound legal strategy and minimize the government's costs.

Justification

The Director of Privatization Strategies Program Office, Headquarters Air Force, Engineering and Services Center, Tyndall AFB, Florida, sponsored this research effort. The desired goal was to further the research of PSF

and provide a centralized document for Air Force members to find answers to their many questions on PSF.

Research Objectives

The overall objective of this research was to gather data, from an extensive literature review and through interviews, to identify costs of PSF projects associated with the various legal issues. To accomplish this goal, it is necessary to:

1. Determine what are the Air Force regulations, the DOD regulations, and the existing public law governing PSF.
2. Investigate to see what PSF projects throughout the DOD have been completed and what future projects are proposed.
3. Determine the required conditions for a facility project to be considered for PSF.
4. Identify unresolved legal issues which affect an entrepreneur's performance costs on a government PSF contract.
5. Collect opinions on the unresolved legal issues from government lawyers, experienced with PSF projects.
6. Synthesize the data collected on the various legal issues into recommendations for future PSF project.

Research Questions

To accomplish the research objectives, data was gathered to answer the following questions:

1. What are the Public Laws governing PSF and what are the individual requirements stated in each law?
2. How has the DOD used the individual PSF laws to date and what problems have been encountered?
3. Who is responsible for the long-term maintenance of these contractor designed and constructed facilities?
4. Are PSF construction projects on military reservations subject to state, county, and city taxes?
5. Does the Davis-Bacon Wage Act, which calls for prevailing wage rates, apply to PSF projects?
6. Due to the longer period of time required for the Air Force to make a contract award on a private-sector project, than on a normal contract, is it allowable for contractors to tie their proposed facility rates to a floating prime rate?
7. What are the factor(s) which determine if a facility will be a PSF or a MCP project?

Scope and Limitations

A complete examination of PSF would research the legal issues and requirements, the available contracting methods, the economic impacts, the facility design requirements, and maintenance of facilities completed by PSF. Due to time limitations, this research examines only the PSF requirements established by law, unresolved legal questions, and provides some actual examples of PSF applications.

Again, due to time limitations, the research is limited to examining construction projects which exceed one million dollars in project costs and only those projects occurring within the continental U.S.

II. Methodology

Chapter Overview

This chapter describes how the research was performed to resolve the research objectives and research questions posed in Chapter I. In particular, this chapter describes sources of information and legal opinions, the method of collection, and organization of the information and legal opinions.

Sources of Information and Legal Opinions

Wright-Patterson AFB (WPAFB) is in the center of the Air Force's private sector financing (PSF) development. WPAFB is the proposed site for two of the Air Force's lead PSF projects. The first project is a 250-room hotel/conference center. The second project is a 760,000 square feet office complex for Aeronautical Systems Division (ASD). While the concept of PSF is easily understood, the specific governmental mechanisms which authorize these ventures were not.

Initially, several professors on the Air Force Institute of Technology (AFIT) faculty were consulted to learn what controls these projects. While many were interested and understood the concept, none knew what mechanisms controlled these types of projects. Next, the project managers, for the WPAFB hotel and the ASD office complex were consulted. They provided the enabling legislation

under which they were working. However, many of the research questions could not be answered and they directed the researcher on to two more offices. First was the Program Office for Privatization Strategies at the Engineering and Services Center, Tyndall AFB, Florida, which is charged with developing Air Force policy on PSF of facilities. The second office was that of the General Counsel for the Secretary of the Air Force. Both of these offices were staffed with extremely knowledgeable individuals and provided assistance in answering questions and giving guidance.

Both of these offices referenced public laws or U.S. Statutes which regulate the DOD's PSF projects since no specific DOD or USAF regulations on the topic exist. Extensive examination of these statutes provided a starting knowledge base for the research.

Research Population. Much of the initial research was spent identifying anyone with knowledge of PSF. Preliminary research revealed approximately 20 USAF projects of various types which were beyond the discussion stage (7). The number of USAF employees knowledgeable with PSF was about the same number (40). Additionally, this population was easily divided into two groups, lawyers and laymen. Laymen is used to describe all members of the research population, who were not lawyers. The majority of the knowledgeable lawyers were found at the Secretary of the Air Force level and at Headquarters (HQ) Air Force. The

government laymen group included project engineers, contracting officers, economists, and real estate officers. They were found at the Secretary of the Air Force and HQ USAF levels and at WPAFB.

Due to the small population available within the Air Force, the research was expanded to both the Departments of the Army and the Navy. This expansion was appropriate since both sister services were in the same stage of PSF development and had their central PSF development organizations in the Washington D.C. area (40). Also, all of the services are required to adhere to the same public laws. The Navy centralized all of their PSF development in the Facilities Development Division of the Naval Facilities Engineering Command (23). The Army was more decentralized with two groups, the Office of the Chief Engineers, U.S. Army Corps of Engineers and the U.S. Army Community and Family Support Center leading the development of PSF (27; 37).

Method of Collection

The first method of data collection was an extensive literature review. This literature review allowed the examination of both primary and secondary data. The primary data collected in the literature review came from the U.S. Statutes and the Congressional record which provide the federal law regulating the DOD in PSF projects. The following statutes were examined:

Title 10 USC 2662. Real Property Transactions
Title 10 USC 2667. Leases: Non-Excess Property
Title 10 USC 2809. Long-Term Facilities Contract Test
Title 10 USC 2821. Housing Rental Guarantee
Title 10 USC 2828. Military Family Housing Leasing
Title 40 USC 481. Property Management
Title 40 USC 490. Operation of Buildings

Secondary data came from books, periodicals, government documents, and previous research by others.

Interviewing was the second method of data collection. Interviews were conducted either in person or over the telephone, from November 1987 through July 1988.

The personal interviews were conducted in three major groups. The first group of interviews were conducted at WPAFB, where two of the largest PSF projects are in progress. The second group was conducted at the USAF Privatization Policy Meeting in Washington, D.C., on 11-14 January 1988. The last group of interviews was again conducted in Washington, D.C., on 27-30 June 1988. These last interviewees were from the Department of the Army and Navy.

At the beginning of each interview, the subjects were asked demographic questions about their positions and backgrounds, previous experience in the construction of facilities, and their experience with PSF. The DOD's use of PSF seemed to be segmented into major groups. It was the rare individual that was knowledgeable or even felt comfortable discussing all of the different types of DOD PSF. A structured interview or questionnaire would not have worked due to the widely varied knowledge base of the respondents. For

this reason, the semi-structured interview was selected since it allowed the interviewer to direct the interview into topic areas where the subject was familiar. Additionally, the depth and detail of information that was gained, far exceeded that which could be obtained in a mail survey (19:160).

One concern with personal interviewing is the potential for interview bias affecting the results (19:161). A biased interviewer can distort information through use of "inappropriate suggestions, word emphasis, tone of voice, and question rephrasing" (19:167). While interviewer bias is a possibility, three factors work to minimize it. First, the segment of the research population earlier identified as the laymen typically only provided their personal experiences and refrained from providing legal opinions. The second group, the lawyers provided their opinions on questions they had previously researched. The lawyers often took the liberty and assisted the interviewer in rephrasing the question to insure that little was left to be misconstrued. Lastly, the majority of the interviews were of an exploratory nature and the interviewer was obtaining facts and not opinions from the respondents.

Organization of the Data

As the data gathering progressed, it became more and more apparent that one factor directly affected the outcome of the research questions. This was that the DOD has many

different avenues in which it can pursue PSF. Each avenue exists because of a different enabling legislation or law. Additionally, many of the individuals laws provide the DOD various options in developing a PSF project. Due to time constraints, the research was narrowed into three avenues of PSF of facilities. Often a particular law or even an option in the law could affect the outcome of a research question. To simplify the organization of the data and later presentation of results, the data was matrixed into the following three major groups: (1) outleasing, (2) long-term facility contracts, and (3) military family housing. This simplified the organization since the majority of the literature was found in one of these general areas. These three general areas are later used as separate chapters in the presentation of results.

Potentially, these explanations of various PSF approaches and the answers to the research questions can assist in the development of future PSF projects. To allow future readers of this document to rapidly find facts about these three types of PSF, a table is provided in Appendix A. The readers must realize that virtually all legal opinions have a counter or opposite viewpoint. The final truth or point of law will come only after many of these opinions are tested in the courts.

III. Outleasing

Chapter Overview

A discussion of information pertaining to outleasing, obtained through an extensive literature review and personal interviews, is presented in this chapter. An outlease is the government leasing its land to a state or private enterprise. Outleases are often required in conjunction with other private sector financing (PSF) laws, where an entrepreneur builds on government land. But, outleasing may be used by itself and not in conjunction with other legislation. Outleasing, when used by itself, is one of the most creative PSF approaches (40; 80). This chapter's examination of outleasing is divided into the following: (1) a definition of outleasing, (2) a discussion of the laws that regulate outleasing, and (3) experiences to date using outleasing.

A Definition of Outleasing

Outleasing, sometimes referred to as an outgranting, is the government leasing a parcel of land to a private party (2:2-11). With regards to PSF, the purpose of outleasing is for the lessee to construct a facility and/or perform a service for the military using private sector funds (2:2-11). By law, the military is not allowed to provide any guarantees to the entrepreneur with federally appropriated funds (27; 30:5; 35).

A Discussion of the Laws that Regulate Outleasing

Authority for outleasing military lands is specifically covered under Title 10 USC 2667. Leases: Non-Excess Property (75:630). When the government uses this enabling legislation alone, the Federal Acquisition Regulations do not apply and a great amount of leeway is available in structuring the lease (31:2; 35). However, the Service Secretaries have extended a general policy of open competition to cover all outleasing (31:2).

While the authority to outlease military land is given to the respective Service Secretary, another law dictates who must be given notification of the lease. Title 10 USC 2662. Real Property Transactions: Reports to the Armed Services Committees requires a 30-day notification of the Senate and House of Representatives when the annual fair market rental value is in excess of \$100,00 (74:600). Additionally, this law requires an annual report to Congress of all the leases with an annual rent between \$5,000 and \$100,00 (74:600).

What the Law Says. A Service Secretary may lease military land to a state government, local government, or private party if he determine the lease is advantageous to the U.S. (75:630). The terms of the lease are structured to promote national defense or be in the public interest (75:630). Property to be considered for outlease must be under the control of the military, not needed for public use, and not considered excess property (75:630). Often

terms have been written to require construction of facilities by the lessee (2:2-11).

How It Works. Outleasing of government land to entrepreneurs on the condition that the entrepreneur construct a facility and/or provide a service to the military is one of the most creative forms of PSF (11; 40; 80). This PSF approach has the unique ability to provide a usable facility which costs the government only the price of preparing and awarding a lease (11). The entrepreneurs are compensated for their investment through service charges as the facility and/or services are used by the military (27; 40). Thus, the military avoids any large, upfront capital construction outlays (40; 80; 87:1).

Outleasing of government land is often performed in conjunction with other contracts which are regulated by other federal laws. However, if Title 10 USC 2667 is used by itself, the military has no authority to provide a financial guarantee of revenues with appropriated funds (27; 30:6; 35). The entrepreneur must assess the risk of the investment after reviewing an analysis of the projected market. A projected market analysis may be provided by the government (25; 27; 84). But the entrepreneur must validate this market projection or perform his own analysis. The government's projected analysis is not a guarantee of a future market and is provided with a full disclaimer to the prospective entrepreneurs (40; 84). Additionally, a financial institution loaning money to the entrepreneur will

probably require an independent market analysis (42; 47). One approach to encourage entrepreneurs and satisfy financiers' requirements, is the guarantee of a minimal cash flow sufficient to satisfy the payment of debt on the project with non-appropriated funds (27). Still, an entrepreneur only commits to a venture if there is a high probability of an acceptable return on his investment (2:2-11).

Ownership and Right to Title. A lease grants the lessee the right to possess, use and enjoy a parcel of land for the term of the lease (31:1). Ownership of the land, however, is retained by the government through the term of the lease (31:1; 35). The lease under Title 10 USC 2667 must allow for revocation at anytime by the government, unless the Service Secretary determines omission of a revocation clause is in the best interest of the service or the public (75:630). In the event the lease is revoked by the Service Secretary to allow for sale of the property, the lessee has the first right to purchase the property (75:630).

Terms of the lease often require the lessee to construct facilities on government land. Title to these facilities is established in the lease. Usually the title for the facility remains with the lessee for the period of the lease (75:635). Upon expiration of the lease, a number of options exist for disposition of these facilities and these land options should be addressed in the lease (27). Some of the common options are renewal of the lease, sale of

the facilities to the government, removal of the facilities and restoration of the land by the lessee, abandonment by the lessee in lieu of removal, or title passage to the government (11; 27). Where the lessee by terms in the lease has the option to remove the facilities or abandon them and he elects to abandon them, the title passes to the government (75:635). This matter of law is established under the court decision, Meade Heights, Inc. v. State Tax Commission, 1953 95 A.2d280, 202 Md.20 (75:635). The decision states that if the lessee elects not to remove the improvements, then title to the improvements would become property of the government (75:635).

If the military's plan is for the government to acquire the property at the end of the lease, a Congressional authorization would be required (30:9; 68:1). In an outlease with Holiday Inn for a hotel at Ft. Drum, New York, the ownership of the facility reverts to a non-appropriated fund and not the government (27; 66). This way any accusations of incremental funding of the facility are avoided.

Rental Rate. Many PSF outleasing projects call for the entrepreneur to pay a nominal rent for the term of the lease (32:20). Two hotel projects, one at Nellis AFB, Nevada, and one at WPAFB, Ohio, called for a rent of one dollar for the entire 40-year term (84). Money rentals directly received by the military, under a lease for PSF, are entered into the Treasury as miscellaneous receipts (75:630).

Under many leases, the lessee is provided with an option for access to government utilities or services (27; 84). The government's intent in offering the contractor access to the closest and/or the cheapest utility service is to lower the entrepreneur's costs (40). The contractor must then directly reimburse the local military installation for all utilities and services used (40; 75:631).

Another possible way for the government to charge an entrepreneur for leasing the land is to tax their operation like a city charges a sales tax. The PSF lodging contract at Ft. Drum has a "contract administration fee" of one dollar payable for every room night charged by the entrepreneur (26; 27; 66:1). This fee is paid to the non-appropriated fund to offset the cost of administering the lease (27). It should be noted that the Ft. Drum hotel contract was a unique case whereby a minimal cash flow was guaranteed to the contractor with non-appropriated funds (27). Since the government cannot guarantee any federally appropriated funds to the contractor using this sole legislation, the Army elected to use non-appropriated funds (27).

Term of the Lease. The length of the lease may be for any period of time (53; 75:630). The length of the term typically coincides with the economic life of the facility (40). The military Service Secretary determines the term that best promotes the national defense or the public good (53; 75:630).

Construction Standards. If construction of a facility is a requirement of the lease, the government has the right to establish minimal construction standards in the lease (32:1; 35). However, the military must realize that the facility is owned by the lessee. The government's concern for safety can be obtained by using the local construction standards and building codes (23; 40; 80). In the hotel projects at WPAFB, Ohio, and Nellis AFB, Nevada, the government used a performance specification calling for nationally recognized construction codes (40; 80). The intent was to avoid the typical, complex, government construction specification, which might stifle the private entrepreneur, who normally builds and operates hotels professionally (40; 53).

Maintenance Responsibility. This responsibility rests solely with the entrepreneur (11; 53). For the government to assume this responsibility would require funding and the government is not allowed to use appropriated funds. However, logical deviations to accommodate local conditions are understandable if the contractor reimburses the government (27; 40; 53). In the Ft. Drum lease, the Army provided for snow removal with the entrepreneur reimbursing the Army for this maintenance service (27; 66).

Enforcement of Standards. Standards of construction, operation, and maintenance of facilities or services may be established in the lease. Failure by the lessee to follow standards and terms of the lease is a breach for the

lease. The lessee is motivated to avoid a breach of the lease since it can lead to a lease termination. In the WPAFB Hotel and Conference Center Request for Proposal (RFP), a sample lease was provided to prospective entrepreneurs (25:A2). This sample lease, in clear and concise terms, listed the termination procedures to be followed by the government in the event of a breach by the lessee (25:A2-12).

Using a performance specification from the RFP and the local/national building codes, the entrepreneur establishes the final standards in his proposal (23; 40; 80). The entrepreneur's standards of construction and facility design need to be a major area of evaluation in the selection of the winning proposal (23; 40; 80). Insuring these construction standards will be a major challenge for the military (23; 27; 80). The local and national construction codes are often unfamiliar to military inspectors, who are familiar with used to military construction standards (23; 27; 37). To date, the outlease projects have relied on local inspectors to insure adherence to the local building codes (23; 53). However, on bases where the military has exclusive jurisdiction, a more prudent approach would be to retain an architectural and engineering (A&E) firm for construction management (23). This would also insure inspection in the absence of a quality local building department (23; 80).

Another motivation for the entrepreneur to maintain high operating standards is pressure from competitors. The

U.S. Government does not guarantee the military will use the entrepreneur's services. While a creative arrangement may allow for a guaranteed cashflow with non-appropriated funds sufficient to make payments on the mortgage, it should not provide for a profit (27). Consequently, the entrepreneur is motivated to provide a quality product.

A great deal of leverage over the entrepreneur exists since the local commander may be able to control the market. PSF ventures can occur within the confines of a closed base or closed post, thus, restricting entry by gate guards. While the entrepreneur holds the title to his facilities, the military may completely control access to them. As a condition of the lease proposed in the WPAFB Hotel RFP, occupancy was limited to government employees or others as directed by the Base Commander (25:A3-6). This leverage is yet another avenue to insure that operating standards of the lease are met.

While the military must enforce standards, excessive control and termination provisions in the lease may prevent entrepreneurs from even responding to RFPs issued by the government (2:4-24; 40; 80). Entrepreneurs will only respond to a RFP if they are reasonably assured of an acceptable rate of return on their investment (15:5-1; 60:8). Interestingly, in PSF ventures, the Navy's policy is that, "Navy control is not good business" (15:5-1). The Navy realizes a private entrepreneur succeeds in the marketplace by devising more efficient ways to do business

(15:5-1). The Navy believes that for the Navy to benefit from an entrepreneur's operation, the PSF venture must be allowed to operate like the "outside world" (15:5-1).

Impact on the DOD Budget. The concept behind a potential PSF venture is for the military to benefit from the entrepreneur's expertise, thereby reducing construction and operating costs (13:57). In this case, overall life cycle costs are also reduced. Additionally, the military avoids funding large, upfront facility and equipment costs in a single year (42; 80; 87). The military is instead able to expense these costs over the life of the facility (61).

Before any PSF venture is allowed to go forward, the project engineer must examine the economics of all possible options using a life cycle analysis (40; 61; 80). Typically, three possible options exist.

The first option often exercised is to do nothing or maintain "status quo" (25:3-28; 84). For the WPAFB hotel, this option meant calculating the cost of sending the military visitors in excess of the base's billeting capacity to nearby civilian motels and hotels (25:3-28; 84). These costs are a matter of historical record.

The second option involves the military using the military construction process (MCP) to construct and operate needed facilities (25:3-28). The facility's cost can be estimated using other similar military construction project costs (80). In the Air Force, the project engineer can use the MCP pricing guide (40). This guide provides an average

cost per square foot for a certain type of facility. The engineer can modify this cost for facility size, geographical location, and other factors. Additionally, the maintenance costs of similar military facilities are a matter of historical record (82).

The last option, a PSF venture, can be obtained from the life cycle costs of private industry. Most large corporations track their costs to measure the performance of their different operations (82). The only cost component in a private industry's operation not relevant in an outlease is the cost of land, as it is essentially free (82). The capital cost component for land should be subtracted from the private-sector costs to obtain a realistic estimate (82).

If the analysis of these options indicates the PSF option to be the most cost effective, the RFP is issued. After receipt of the entrepreneur's proposals and the government's evaluation process, the best proposal provides the military with a validated cost for the entrepreneur's services and facilities (82). Now, the economic analysis of options is performed again using the entrepreneur's actual rates (82). If the entrepreneur's rates are not less than the costs of the other options, the military is not obligated to sign a lease (82).

An outlease without any guarantee of appropriated funds impact the DOD budget by not requiring funding for the capital costs of construction and operating equipment in the

first fiscal year (40; 61; 80). Instead, this initial investment in capital goods is paid by the entrepreneur (40; 61; 80). Later this investment is recovered by charging the individual military member using the entrepreneur's services (40; 61; 80). Outleasing provides the military the ability to "pay as you go" (80). In austere budget years outleasing will be very attractive for the military (40).

Applicability of State, County, and City Taxes.

While the military, as an agent of the sovereign, does not pay taxes, entrepreneurs may find themselves liable for taxes in a PSF venture (53). An entrepreneur's tax liabilities raise his operating costs and are relevant in the government's economic analysis of the options open to them (61). According to Title 10 USC 2667:

The interest for a lessee of property leased under this section may be taxed by State or local governments. A lease under this section shall provide that, if and to the extent that the leased property is later made taxable by State or local governments under an Act of Congress, the lease shall be renegotiated [75:631].

Another law, Title 4 USC 105. State, and So Forth, Taxation Affecting Federal Areas; Sales or Use Tax, directly addresses taxing an entrepreneur's operations on federal lands. According to Title 4 USC 105:

No person shall be relieved from liability for payment of, collection of, accounting for any sales or use tax levied by any State, or by any duly constituted taxing authority therein, having jurisdiction to levy such a tax, on the ground that the sale or use, with respect to which such

tax is levied, occurred in whole or in part within a Federal area; and such State or taxing authority shall have full jurisdiction and power to levy and collect any such tax in any Federal area within such State to the same extent and with the same effect as though such area was not a Federal area [68:1124].

Congress, under this title, intended to recede to the state sufficient sovereignty over federal areas and to allow the state to levy and collect taxes (70:1125). Another statute addresses the collection of income taxes on federal lands by the states.

Title 4 USC 106. State, and So Forth, Taxation
Affecting Federal Areas; Income Tax states that a state may levy and collect income taxes from an entrepreneur's operations on federal lands (71:1127). This statute is as follows:

No person shall be relieved from liability for any income tax levied by any State, or by any duly constituted taxing authority therein, having jurisdiction to levy such a tax, by reason of his residing within a Federal area or receiving income from transactions occurring or services performed in such areas; and such State or taxing authority shall have full jurisdiction and power to levy and collect such tax in any Federal area within such State to the same extent and with the same effect as though such area was not a Federal area [71:1127].

Again, under this title, Congress intended to recede to the state sufficient sovereignty over federal areas, to allow the state to levy and collect taxes (70:1125). However, another statute prevents a state from directly taxing the federal government.

Title 4 USC 107. State, and So Forth, Taxation
Affecting Federal Areas; Exception of the United States, Its
Instrumentalities, and Authorized Purchases Therefrom stops
the states from taxing the "sale, purchase, storage, or use
of tangible personal property sold by the United States or
any instrumentality thereof to any authorized purchaser"
(72:1131). An authorized purchaser is defined in the
following:

A person shall be deemed to be an authorized
purchaser under this section only with respect to
purchases which he is permitted to make from
commissaries, ship's stores, or voluntary unincor-
porated organizations of personnel of any branch
of the Armed Forces of the United States, . . .
[72:1131].

While this law exempts the non-appropriated funds organiza-
tions like the Army and Air Force Exchange Service (AFFES)
from local taxes, a concessionaire to AFFES is not exempt
from taxes (72:1132). In Bullock v. W & W Vending and Food
Service of Texas, Inc., a sales tax was held to be valid on
concession sales made by a concessionaire to the AFFES
(72:1131). The Burger King restaurants, that operate under
a franchise agreement with AFFES, collect state sales taxes.
Another statute addresses the state's right to annex
federal lands.

State and local governments can annex military lands
and collect taxes on private ventures operating on outleased
lands (53). Title 4 USC 108. State, and So Forth, Taxa-
tion Affecting Federal Areas; Jurisdiction of United States

over Federal Areas Unaffected states that the intent of Titles 4 USC (105-110) is not to deprive the Federal government of its right to exclusive jurisdiction on its own lands (73:1132). But, even exclusive jurisdiction does not prevent a taxing authority from annexing federal lands (73:1133). In the case, Flynn v. Stevenson, a naval station on which the Navy had exclusive jurisdiction was validly annexed by a municipality (73:1133). Many federal laws give the states and their taxing authorities the ability to collect taxes from entrepreneurs operating on military lands (53).

Applicability of the Davis-Bacon Wage Act. If prevailing wages must be paid due to the Davis-Bacon Wage Act, the cost of construction is increased for the entrepreneur. The most reputable studies have found that a project constructed under Davis-Bacon costs between 3.4 and 5.6 percent more than the same project without it (8:108).

The opinions of general counsel for both the Navy and the Air Force is that the Davis-Bacon Wage Act does not apply to entrepreneur's facilities constructed under an outlease (31:2; 35; 53). The basis for this opinion is that the military is not expending appropriated funds for the construction of the facility, rather, the contractor is using private funds (35). The contractor receives a return on his investment from the military employees, who later pay to use the facility and/or service (30:10; 35). Also, the facility is owned by the entrepreneur for the facility's entire

economic life (30:11; 35). Lastly, the government makes no guarantee to use the facility, nor are federally appropriated funds guaranteed (30:11; 35).

On January 28, 1988, this opinion was challenged by Mr. George Long, a business representative for the Miami Valley Carpenter's District Council of Dayton, Ohio, in a letter to U.S. Senator Howard Metzenbaum, Chairman of the U.S. Senate Subcommittee on Labor and Human Resources (36:1; 41:1). The Air Force replied to this Congressional inquiry by stating it was not circumventing the Davis-Bacon Wage Act on the hotel outlease at WPAFB (64:1). The Air Force provided judicial support of it's position with the case, U.S. v. Centerline Gardens, Incorporated, 253 F.2d 133 (5th Cir. 1958) (64:2). In that case,

The Court of Appeals determined that the lease of land to a developer for construction of Wherry housing for military families was not a contract for a "public work," even though construction was contemplated under the lease [64:2].

Following the applicability of Davis-Bacon, the next hurdle will be the prevailing wage laws in many states.

Minimal Requirements. Assuming the military owns the land, other requirements must be met before the military may proceed with a PSF project solely under Title 10 USC 2667 (60:7). A valid need for the project must exist (60:7). Just like an MCP, a PSF project must be fully justified by the organizational mission (15:6-1). Next, an economic analysis must justify PSF over all other options

(15:6-1; 80). The project must have Congressional support (60:8). A minimal requirement for Congress, is the completion of an environmental impact study (2:4-15; 60:13). It will need to address the physical effect of the construction, as well as socioeconomic impact on the community (2:4-8). This means the PSF venture must have local support or at least not opposition, as Congress is sensitive to claims of unfair competition against off-base businesses (2:4-8; 15:5-2; 16:2). Last, the private sector must be interested in the venture (2:4-8; 15:5-1; 60:7). The entrepreneurs will only be interested if the potential venture provides an acceptable return on their investment (15:5-2; 60:8; 80). All of these requirements must be met before an outlease is even possible (60:7; 80).

Who Must Approve. Under Title 10 USC 2667, the individual with the authority to enter into a lease is a Service Secretary (75:630). A separate legislation, Title 10 USC 2662. Real Property Transactions: Reports to the Armed Services Committees, requires Congressional notification on all leases where "the expected annual fair market rental value of the property is more than \$100,000" (74:600). As a matter of general policy, the Department of Defense requires all military services to notify Congress of all PSF outleases 30 days prior to entering an outlease (80). The specific committees which are notified are:

1. Subcommittee of Readiness, Committee on Armed Services (HOUSE).

2. Subcommittee on Military Construction, Committee on Appropriations (HOUSE).
3. Subcommittee on Military Construction, Committee on Appropriations (SENATE).
4. Subcommittee on Military Construction, Committee on Armed Services (SENATE) (53).

While these committees are interested in reducing expenditures, they are also sensitive to the potential criticism of on-base entrepreneurs competing unfairly with the existing off-base facilities (16:2).

Experiences to Date

The Army Morale, Welfare and Recreation (MWR) Fund entered into an agreement with Holiday Inn, Incorporated, on 23 April 1987 for construction of a transient living facility at Ft. Drum, New York (66). This project is presently under construction (27). The interesting point of the Ft. Drum lease is that financial guarantees are made to the entrepreneur (27). By law, the Army is unable to make any guarantees which could commit or expend federal funds (27). However, the Army MWR Fund is able to make financial guarantees using non-appropriated funds (27). Also, at the end of the lease, Holiday Inn, Incorporated, turns over title of the facilities to MWR Fund, not the government (27; 66).

Lt Col Brian Japak, the contracting officer on the Ft. Drum hotel wrote a memorandum on the lessons-learned from that outlease (26:1). Some of his major lessons-learned are listed below:

1. If we are to be successful, this facility needs to be run by hotel professionals as a commercial facility for the benefit of the soldiers and everybody else is cut out.

2. There is a basic equation, Room Rates = Facilities. We either say what the room rates are and let industry dictate the facility, or we dictate the facility and let industry determine the room rates. We cannot dictate both sides of the equation and successfully negotiate a contract.

3. Entrepreneurs evaluate the proposed projects from an income stream viewpoint, how many potential income streams are there and what is their value. The more potential income streams we can provide the better our negotiating position (also the lower the entrepreneur's risk). The more qualifications and controls we impose the less appealing the deal will be for the Contractor. For example, locating a TLF in the middle of the post, restricting authorized users, no foods or beverage operations, and/or no concessionaires, all reduce income streams.

4. The number of government players, the turnover of government players, and the roles of the government players (approval and information) result in mass confusion. The role of the NAF contracting officer is complicated by the number of players and organizations who feel they must review the statements of work, solicitations, participate on technical review of proposals, and review the proposed contracts.

5. The most frustrating portion of the Fort Drum TLF process was the role of the CFSC SJA office and the Fort Drum SJA office. I strongly recommend an exception be pursued to allow for contact legal support with expertise in the commercial lodging industry. This contract must be approved by the Army Secretariat Office who gets Army General Council review. This should be sufficient review (26:2).

The above lessons-learned should assist the military in future outleases for hotels. Also, many of these lessons apply to other types of PSF projects.

IV. Long-Term Facilities Contracts

Chapter Overview

This chapter presents information on long-term facilities contracts obtained through personal interviews and a literature review. A long-term facilities contract is another form of PSF. While similar to an outlease, the difference lies in that a long-term facilities contract provides the entrepreneur with a federally guaranteed cash-flow. The chapter is divided into the following: (1) a definition of a long-term facilities contract, (2) a discussion of the laws regulating long-term facilities contracts, and (3) long-term facilities contract experiences to date.

Definition of Long-term Facilities Contracting

Long-term facilities contracting allows the military to contract for the construction, management, and operation of a facility on or near a military installation for up to 20 years (77:308). Just as in an outlease, the entrepreneur provides the financing, design, construction, and operation of the facility. Unlike a straight outlease, a long-term contract provides a financial guarantee backed by federally appropriated funds (37). In a long-term facility contract, the government contracts for a service for 20 years and the entrepreneur builds a facility which allows him to provide that service (37; 80). An example would be, the Air Force contracting with entrepreneur for vehicle maintenance over a

20-year period (37). The entrepreneur then finances, designs, and builds a maintenance facility, complete with equipment for his technicians (37). The entrepreneur's capital investment in these facilities is returned each month in the government's payments for repair services (37).

Discussion of the Laws Regulating Long-Term Facilities Contracts

Authority for long-term facilities contracts is covered under Title 10 USC 2809. Test of Long-Term Facilities Contracts (77:308). Many long-term contracts will occur on government land. This will require the military to outlease land to the entrepreneur concurrent with the long-term facilities contract (37). Outleases, as addressed in the previous chapter, are covered under Title 10 USC 2667. Leases of Non-Excess Property (75:630). Should the outlease be required, Title 10 USC 2662. Real Property Transactions: Reports to the Armed Services Committees states that appropriate Congressional committees must be notified prior to an outlease (74:599).

What the Law Says. The Secretary of a military service:

may enter into contract for the construction, management, and operation of a facility on or near a military installation for the provision of an activity or service in the following categories:

- (i). Child care services,
- (ii). Potable and waste water treatment services,
- (iii). Depot supply activities,
- (iv). Troop housing,
- (v). Transient housing,

- (vi). Hospital or medical facilities,
- (vii). Other logistic and administrative services,
other than depot maintenance [77:308].

Because the long-term facilities contracting legislation is a test, each Service Secretary is limited to five total contracts with the exception of child care center, for which the number is unlimited (77:308). The authority for this test legislation expires on September 30, 1989, and all contracts must be entered into by that date (77:309).

Long-term contracting is not intended to be a way around or to avoid the MCP process (80). To insure this, the Service Secretary requesting a facility must provide a justification of the need and an economic analysis of all options using lifecycle costing to Congress (77:308). Then, Congress has a period of 21 days to review the submittal before contract award (77:309).

How the Law Works. The concept of long-term facility contracting allows the military to contract for a needed service, which is readily available in the private sector (61). It is believed that the private sector professionals in a given business can provide that service more efficiently than the military (50). One must keep in mind that the military is contracting for a total service, not just a building (61). Consequently, the entrepreneur amortizes the cost of the facility with each bill collected for services (61). This way the military pays for the facility over the term of the contract, spreading out the large upfront

capital costs (40; 61; 80). If the entrepreneur is allowed to design the facility in accordance with private sector specifications, the government may benefit through reduced construction costs (23; 40; 80). While the military is often accused of "gold plating," no motivation exists for the entrepreneur to over-build (80). The entrepreneur is motivated to construct the most efficient facility needed in conjunction with his contract (80). Long-term facilities contracting is a total approach wrapping up land acquisition, facility design, construction management, facility maintenance and service contracting into one contract (37).

Ownership and Right to Title. Ownership of the land and facilities is established in the lease signed by the Service Secretary and the entrepreneur. Unique circumstances surrounding each long-term contract will prevent the drafters from using a standard "boiler plate" contract (37:1).

Many long-term facilities contracts involve construction of the service facility on government land. In these cases, the entrepreneur's financiers will require an out-lease of the government land for the term of the mortgage (42). This outlease, by law, must allow for revocation at any time by the government, unless the Service Secretary determines omission of a revocation clause is in the public interest (75:630). Should the government ever wish to sell the land, the entrepreneur has first right to purchase the property (75:630).

The right to title of the facility improvements, although located on government land, clearly lies with the entrepreneur during the term of the contract/lease (53). Four simple options exist for the government: (1) renew the contract/lease, (2) purchase the facility improvements from the entrepreneur, (3) require the contractor to remove the improvements, or (4) allow for title passage to the military in lieu of removal (27).

The Service Secretary has the authority to contract for up to 20 years, allowing the entrepreneur sufficient time to amortize his capital investments in facilities and equipment. The entrepreneurs will structure their proposals to retire the mortgage on the facility before expiration of the contract (23; 37; 40; 80). One approach would be for the contract to allow for the facility improvements to be abandoned by the entrepreneur and left for the government. This could be done by the following clause in the lease:

At the end of the lease, upon which time the contractors capital investment costs will be fully amortized, the facility improvements will become the property of the government [66:38].

Another inconspicuous approach to allow for facility ownership at expiration of the lease is:

Upon expiration of this contract the Government shall have the option (a) to take title to all improvements made to the leased premises..., (b) or at its option shall require the contractor to restore the property to its original condition, (c) or a combination of both, all at no cost to the Government [27:22].

Regardless of the lease terminology, Title 10 USC 2809 does not authorize the government to acquire title to facilities through long-term facilities contracts (30:9).

The issue of federal acquisition authority for the acquisition of real property of facilities is specifically addressed by law and has been clearly defined in various Comptroller General decisions [30:9].

Any attempt to acquire possession of facilities through long-term facilities contract is a lease-purchase and will appear to be an end run of the MCP process (80). While authorized to acquire the facility could be obtained by addressing the project as a lease-purchase in the annual Military Construction Act, another problem exists (30:9).

This problem is the Office of Management and Budget requirement of the military to score or authorize the entire contract amount in the first contract year (10; 80). The potential ownership of facility improvements upon contract expiration is clearly one of the largest questions facing long-term facilities contracts (53; 80). Since none of these contracts have been awarded, only time will tell what the answers will be.

If the location of the entrepreneur's facility is on private land, a different situation exists. This situation is similar to the majority of the build/lease military family housing contracts allowed under Title 10 USC 2828 [g]. The present approach for housing leases and the plan for long-term facilities contracts, is for the government to

secure an option for purchase of the land in question, prior to solicitation of the government's request for proposals (37). This option, which is transferable to the successful proposer, guarantees the land for the venture at an acceptable price (18; 37). Additionally, it starts all potential proposers at the same point and provides a project location acceptable to the government (37; 67). Since the facility is located off-base, military commanders may be less compelled to acquire the facilities owned by the entrepreneur.

When located off-base, the entrepreneur amortizes the capital costs for both facilities and land over the term of the contract. The military can still benefit, if it does not acquire the entrepreneur's land and facilities, through the entrepreneur's dedicated services (61). Consider what the government would benefit by owning a facility needing extensive upgrading and equipped with technologically outdated capital equipment? The buildings and much of the equipment would be 20-32 years old. Many present government-owned industrial plants are in this obsolete condition. Should the entrepreneur's building and equipment still be technologically current and the military still in need of the service, the military need only recompute the contract (23). The existing entrepreneur already amortized his capital costs and should be able to offer a lower dollar proposal than their competitors (23).

Rental Rate. The cost of land is a component in an entrepreneur's total cost proposal (39:190-195). If the entrepreneur's facility is located on private land, the land cost is recovered through service charges to the user (39:190-195). Should the entrepreneur's facilities be located on government lands, the military should benefit through reduced service charges (40; 80). The government eliminates this land cost by addressing the rental rate for the land at a nominal rate of a dollar for the term of the lease (32:1).

Term of the Contract. By Title 10 USC 2809, the Service Secretary may contract for any term up to 20 years (77:708). Presently, in the Defense Authorization Bill before President Reagan is an amendment to increase the maximum contract period to 32 years to coincide with the new federal income tax laws for depreciation (53; 56; 80). Lastly, these contracts can be renewed with a regular service contract, since the facilities are already in place (2:2-8).

Construction Standards. Standards for construction is another area which cannot be addressed in a "boiler plate" approach (37). Many believe allowing the entrepreneur to design the facility from a performance specification and local building codes is the best way to go (23; 37). This arrangement will be the case in the majority of the long-term contracts (23; 37; 40). Some contracts will require facilities with requirements unique to the military

(23; 37). In these situations, the military may be prudent to provide a partial or even full facility design along with the request for proposal (37). On large projects, the cost for an entrepreneur to prepare an acceptable proposal may exceed one million dollars (56). With proposal costs this high, the military might consider retaining an A&E firm for the design (37; 56). A military funded design of complex facilities would reduce proposal costs for the entrepreneurs and might increase the number of proposals submitted by the private sector on complex facilities (37; 56).

Maintenance Responsibility. Maintenance is not specifically referenced in Title 10 USC 2809 (77:308). The law reads "Contract for the construction, management and operation of the facility . . ." (77:308). The intent by these words is for the contractor to assume maintenance responsibility (53; 80).

Motivation exists for the military to have the entrepreneur maintain and accept liability for the facility and the following situations support this (53). One situation involves the military selecting an entrepreneur with a poor design and using inferior building materials (53; 56). This facility could become a costly maintenance problem (56). Another situation is if the entrepreneur contracts to build a top-notch facility and during construction builds a cheaper facility (56). Military contracting officers and inspectors work to insure neither situation occurs (80). Yet, whether by an inexperienced government agent or a

shrewd construction contractor, it will occur (58). In these situations, the military is theoretically protected if the builder and maintainer are one in the same (53).

Enforcement of Standards. Standards of construction, operation, and maintenance of facilities or services are established in the long-term contract (80). Failure by the entrepreneur to follow the standards and terms of the contract is a breach. The entrepreneur is motivated to avoid a breach of the lease, as it can lead to a termination for default (80). The default clause, required by the FAR, lists the termination procedures to be followed by the government (80).

When the RFP uses a performance specification and the local/national building codes, the entrepreneur established the final construction standards in his proposal to the military (40; 80). The proposer's design and construction standards are a major factor in the source selection (23; 40; 80). Insuring these proposed construction standards are used will be a major challenge for the military (23; 27; 80).

Each entrepreneur should be required to submit a construction quality control plan in his proposal (23; 53). These quality control plans typically call for the contractor to retain an independent inspector for the job. Next, local government (City, County, etc.) inspectors will insure adherence to the applicable building codes (23; 53). On bases with exclusive jurisdiction, the local inspectors may

not have inspection authority or even exist in the area (23). Without local inspectors, many commanders will assign this inspection responsibility to the military (23; 27; 37). Perhaps a more prudent approach would be to retain an Architectural and Engineering (A&E) firm for construction management and inspection (23; 27). But, with long-term facilities contracting, no funds are automatically authorized to pay for inspection services (23).

Under the FARS default clause, a contractor could be terminated for default and left with a facility on government property with no way of operating it to pay the mortgage (80). With this the case, lenders are not willing to make loans, unless at exorbitant rates (80). The Office of the Assistant Secretary of Defense for Production and Logistics recently obtained a deviation to the FARS default clause for long-term facilities contracts (80). The default clause may now be addressed in two parts (80). The first part covers construction of the facility with a standard FARS default clause (80). The other part, after the government's acceptance of the facility, allows the military to terminate only the service portion of the contract (80). This way the mortgage bankers are guaranteed a payment from the military, sufficient to amortize the construction debt (80).

Impact on the DOD Budget. The primary concept behind a potential PSF venture is for the military to benefit from the entrepreneur's expertise, thereby reducing

construction and operating costs (40; 61). In this case, overall lifecycle costs are also reduced. More important, the military avoids funding large upfront facility and equipment costs in a single year (40; 61; 80; 86:2). Instead, the military expenses these costs over the life of the facility (40; 61; 86:2). One question not yet resolved, is whether the entire cost of the contractor's investment will need to be scored or authorized in the first contract year (10; 53; 80)?

This was the case for the Capehart Housing constructed during the 1950's (53). Scoring requires setting aside the total cost of the government's contract liability in the event of a contract termination for a given year (30:4). The total facility cost may be required to be scored even though the military plans to make payments or outlays on a yearly basis (10). "If the service must obligate the entire construction cost, it is more effective to just purchase the facility outright" (30:5). To fully understand the government's termination liability, one must start with an understanding of a contract.

A contract is a promise of performance, which the courts recognize as a legal duty (4:2-1). In the context of a long-term facility contract, the entrepreneur promises to construct a facility and perform a service for the military (40). For this, the military agrees to make payments over the term of the contract (40). Should either party fail to perform according to the contract's terms, the nonperforming

party may be in breach of the contract (4:18-1). The courts allow the wronged party to recover damages for the breach or nonperformance (4:18-1). Should the government wrongfully breach a contract, it is responsible for all costs incurred by the contractor, as well as unearned anticipated profits the contractor would have received (4:18-1; 30:5). However, the FAR requires the government to include a "termination for convenience" clause in all contracts (4:19-1). This mandatory clause is necessary due to:

Changes in military strategic planning -- the development of new weapons -- new attitudes on disarmament, budgeting and funding -- any of these may eliminate the need for part or all of an existing contract [4:19-1].

This clause allows the military to terminate for its convenience due to changes or other uncertainties with installations (4:19-1). Should the government terminate for its convenience, a contract containing this clause, the contractor is allowed to recover all costs incurred, plus a reasonable profit up to the time the contract was terminated (4:19-1). The contractor is not allowed unearned anticipated profits (4:19-1).

The government does not enter a contract with an intent to terminate. Yet, the Comptroller General has repeatedly ruled that an agency must have sufficient funds obligated to cover termination payments (30:5). This coverage is the amount required to be authorized or scored in the first contract year (30:5).

Reducing the government's termination liability reduces the amount to be scored in the first year (30:5). Omitting the "termination for convenience clause" is one step toward reducing the government's termination liability. This clause has been negotiated out of previous lease/build housing contracts at the request of the investment bankers (53; 80). However, this clause is required by Federal Acquisition Regulations (FAR) and if the clause is inadvertently omitted from the contract, it will be read in under the landmark case of G. L. Christian & Associates v. United States (4:19-1; 30:5). With this clause properly omitted, the government is committed to annual payments until expiration of the contract (53). With this the case, an authorization or score large enough to cover a year's operational cost is all that is required. However, the omission of this clause limits the government's options in the event of base closure (53).

A government termination for convenience with the "termination for convenience clause" properly omitted from the contract would be a breach of the contract by the government (85). In this situation, a contractor's claim for payment of anticipatory profits would have great merit and could amount to a sizable sum (85). In the case U.S. v. Behan, the contractor was allowed to recover all costs, as well as profits to be realized if permitted to continue the contract (30:5). The implications of omitting the

"termination for convenience" clause needs to be understood by government contract writers (53).

Applicability of State, County, and City Taxes.

All of these taxes will apply to the entrepreneur's operation, whether located on or off of government lands. A complete discussion of this area is covered in Chapter III, Outleasing, and is unchanged for long-term facilities contracts.

Applicability of the Davis-Bacon Wage Act. All interviews and literature on this topic indicate that Davis-Bacon applies (23; 30:7; 35; 37; 53; 58). The impact of this finding is that all workers constructing the facility must be paid the prevailing wage for the area (69). This means a more costly facility for the entrepreneur to build and thus results in higher service charges for the military (63:1).

Minimal Requirements. The requirements for a long-term facility contract are essentially the same as an outlease (40). Assuming the military owns the land or has acquired an option for its purchase, four other requirements must be met before the military may proceed with a long-term facilities contract. First, a valid need for the project must exist (37; 77:308; 80). Just like an MCP, a long-term facilities contract must be fully justified by the organizational mission (15:6-1; 77:308). Second, an economic analysis using lifecycle costing must show long-term contracting cheaper than all other options (77:308;

80). Third, the project must have Congressional support and approval (77:308). A minimal requirement for Congress, is the completion of an environmental impact study (2:4-8). This study needs to address the physical effect of the construction, as well as the socioeconomic impact on the community (2:4-8). The PSF venture must have local support or at least not opposition, as Congress is sensitive to claims of unfair competition against off-base businesses (16:2). Fourth, the private sector must be interested in the venture (60:5). The entrepreneurs will only be interested if the venture provides an acceptable return on their investment (15:6-1). All of these requirements must be met before a long-term facilities contract is even possible (15:6-1; 80).

Who Must Approve. By law a Service Secretary has the authority to enter into a long-term facility contract (77:308). If an outlease of government lands is required as a condition of the contract, the Service Secretary is also the authority (75:630). Another legislation covering outleasing, Title 10 USC 2662. Real Property Transactions: Reports to the Armed Services Committees, requires Congressional notification on all leases where "the estimated annual fair market rental value of the property is more than \$100,000" (74:600). This notification is a redundant requirement. According to Title 10 USC 2809, the Service Secretary cannot enter a contract until, "the Secretary concerned submits to the appropriate committees of

Congress, in writing, . . . " (77:308). Then, the Service Secretary must wait a period of 21 calendar days before signing the contract (77:309). The same committees receiving notifications for both the long-term facilities contracts and outleases are:

1. Subcommittee of Readiness, Committee on Armed Services (HOUSE).
2. Subcommittee on Military Construction, Committee on Appropriations (HOUSE).
3. Subcommittee on Military Construction, Committee on Appropriations (SENATE).
4. Subcommittee on Military Construction, Committee on Armed Services (SENATE) (53; 80).

While these committees are interested in reducing military expenditures, they are also sensitive to potential criticism of on-base entrepreneurs competing unfairly with the existing off-base facilities (16:2).

Experiences to Date

There are no long-term facilities contracts using Title 10 USC 2809 signed at this time. The largest one planned by the Air Force is ASD 2000, a central office complex for all of Aeronautical Systems Division at Wright-Patterson AFB, Ohio. Readers should contact the ASD Program Manager for updates, as this project will span several years.

V. Build/Lease of Military Family Housing

Chapter Overview

Military members often live in off-base, private sector housing. The availability of affordable housing near many military installations is decreasing (13:58). Military neighborhoods around many metropolitan cities are viewed as slums (23). In some high cost areas, military members are forced to live apart from their families because they are unable to find affordable housing for their families (13:58). In 1987, the Department of Defense (DOD) estimated their military family housing (MFH) deficit at 40,000 units (13:57). Assuming Congress appropriated all of the needed funding for construction of this housing, more than seven years would elapse before the units would be ready (13:58). To combat this shortage of MFH, Congress enacted two programs to test the privatization of the military family housing development process (13:59). This chapter covers 801 housing, the only program which has provided any relief to the military's housing dilemma (18: 34).

This chapter presents a discussion of long-term leasing of military family housing as authorized by Title 10 USC 2828 [g]. The material in this chapter was obtained through a review of the literature and interviews of government employees involved in the 801 housing program. The chapter is divided into: (1) a definition of build/lease of

MFH, (2) a discussion of the laws regulating build/lease of MFH, and (3) experiences to date.

A Definition of Build/Lease of MFH

Leasing of MFH involves a military service leasing housing units from the private sector. The military then assigns the housing units to their service members. In return, the service members forfeit their housing allowances for the privilege of occupying the unit. The concept is not new and is used at many overseas bases (13:58). The following chapter examines this form of PSF which uses the private sector to finance, design, build, and maintain family housing for the military within the United States.

A Discussion of the Laws that Regulate Build/Lease of MFH

Build/lease of MFH within the Continental U.S. commonly referred to as "801 housing" is authorized under Title 10 USC 2828 [g]. Build to Lease (78:315). This law was enacted in 1983 as a limited-duration (two-year) test and has undergone numerous amendments through the years (13:59). Presently, the statute for this pilot program expires on September 20, 1989 (78:316). All contracts using this enabling legislation must be entered into on, or before, this date (78:316).

Should an 801 housing project be located on government land, an outlease of the land to the entrepreneur is required in addition to the MFH agreement. Refer to Chapter

III (Outleasing) for a complete discussion of the statutes covering outleasing.

What the Law Says. This statute allows a Secretary, or the Secretary of Transportation with respect to the Coast Guard, to enter into a contract for the lease of MFH (78:315). This contract may involve the construction or rehabilitation of housing units on or near a military institution with a MFH deficit (78:315). This MFH is to be assigned without rental charge to military members (2:2-14). While the term of the contract is for up to 20 years, the contract must include:

a provision that the obligation of the United States to make payments under the contract in any fiscal year is subject to the availability of appropriations for that purpose [78:315].

The law requires each contract be publicly advertised, and awarded by competitive bid or competitively negotiated contracting procedures (78:315). This provision was made by Congress because a leasing action is not regulated by the Federal Acquisition Regulations (53; 80). Additionally, a contract for the leasing of MFH under this statute may allow for:

the lease of a child care center, civic center building, and similar type buildings constructed for the support of family housing [78:316].

How Build/Lease of MFH Works. A military service only considers an 801 housing project if they have a

validated need for the MFH (78:315). An 801 housing project combines aspects of a construction contract and a triple-net lease (81:1). The military establishes the quantity and minimum construction standards in its RFP to the private sector (13:59; 18; 43; 80). Next, the military secures a purchase option on the land for the planned MFH site (18; 43; 67:1005). The entrepreneur responds to the government's RFP with his proposed facility design and a monthly rental rate for the entire term of the lease (18; 43; 80). The military, using a selection committee, selects the best proposal after considering both cost and quality (18; 43; 61; 80).

After selection of the best proposal, the military submits to the Congressional committees, an economic analysis comparing leasing of MFH to a MCP approach (13:58; 78:315). The economic analysis, using life cycle costing over 20 years, must show the leasing option to be cheaper by at least five percent, or the project is not even submitted to Congress (18; 67:1005; 80). If Congress does not respond within 21 days from receipt of the economic analysis, the respective Secretary may award the contract (13:59; 78:316). To insure the entrepreneurs will perform if awarded a lease, all proposers are required to post proposal bonds (18). Lastly, to insure quality and timely performance, the military requires the winning entrepreneur to post lease, construction performance, and payment bonds (81).

Ownership and Right to Title. While the issue of ownership of land and facility improvements is unclear in other forms of PSF, it is clear for 801 housing. Hundreds of 801 MFH units have already been constructed and this issue resolved.

Title 10 USC 2828 [g] permits the MFH units to be located on or near the military installation (78:315). Several of these projects are already in place on military reservations (13:58; 22). However, the DOD adopted a policy requiring construction of future projects on private lands (18; 80). Next, Congress requires the Secretaries to obtain an option on the proposed land prior to RFP solicitation (18; 67:1005). The rationale for the land option is "to offer all bidders the opportunity to use the same site" (67:1005). The government can spend up to 12 percent of the property's fair market value to secure the land option (76:285). Later, the land is purchased and owned by the successful entrepreneur, although a portion of the military's rent payment ultimately amortizes the entrepreneur's land costs. Ownership of the land lies with the developer.

The MFH units are financed and constructed by the entrepreneur, while the military pays for the right to use them for the term of the lease. The housing units, like the land, are owned by the entrepreneur.

In other forms of PSF, creative contract clauses, which might allow the military to acquire title at the end of the

lease, are used. In the case of 801 housing, the intent of Congress is clear in the following:

A contract under this subsection shall provide that, upon the termination of the lease period, the United States shall have the first right of refusal to acquire all right, title, and interest to the housing facilities constructed and leased under the contract [78:315].

Congress does not intend an 801 housing contract to be a lease/purchase of MFH (80). But Congress does not rule out a separate purchase after the contract expires (78:315).

Rental Rate. To lower the entrepreneur's cost of financing the construction costs, the military adopted a policy of a triple-net lease on all future 801 housing projects (18; 23; 80). A triple-net lease involves the military's assumption of responsibility for the maintenance of the MFH units after their formal acceptance (44:I-2). All increases in taxes and insurance after the second year are also paid by the military (42:I-2; 80). The military even contracts directly with the public utilities for the cost of utilities used by its members (42; 80). This approach eliminates most of the risk for the entrepreneur and his banker by insuring a steady cashflow against a fixed mortgage amortization schedule (42; 80). The military's rent for the MFH can be divided into the following categories:

- a. Land, facilities, and taxes/insurance fixed in the first two contract years;
- b. Maintenance expense;
- c. Utilities expense;

- d. Tax increases;
- e. Insurance increases.

The entire lease arrangement begins to resemble a 20-year housing bond. In fact, the DOD's intention is for the lease to receive at least a AA (investment grade) bond rating (42; 81:1).

Term of the Lease. Title 10 USC 2828 [g] is clear on the Congressional intent of the lease term with:

A contract under this subsection may be for any period not in excess of 20 years (excluding the period required for construction of the housing facilities) [78:315].

After expiration of the lease, the lease may be renewed on a year-to-year basis (2:2-2).

Construction Standards. Title 10 USC 2828 [g] states that "the housing units . . . shall be constructed to Department of Defense specifications" (78:315). In a model RFP issued by the Office of the Secretary Defense, the following building standards and codes are listed:

Federal Manufactured Housing Construction and
Safety Standards (FMHCSS)
National Electric Code
Uniform Plumbing Code
Applicable National Building Code
NFPA 101 Life Safety Code (44:II-3).

The RFP also states that locally adopted codes apply if they are more restrictive (44:II-3). This is quite a change for a military construction inspector accustomed to the detailed Army Corps of Engineer's specifications (37).

The model RFP also provides minimum criteria, or a performance design specification for the entrepreneur to meet (44:II-5). Examples criteria include; minimum appliances, minimum ceiling heights, minimum bedroom widths, minimum size and number of closets, etc. (44:II-10). The 801 housing RFP establishes the minimum design and construction standards, while allowing the entrepreneur maximum flexibility in preparing his proposal. These are key areas in the technical evaluation by military source selection team (44:I-9). Later, the winning entrepreneur's design and standards are incorporated with the RFP to form the contract/lease (80). This approach to 801 housing is best summed up by General Patton's quote, "Never tell people how to do things. Tell them what to do and they surprise you with their ingenuity" (60:6).

Maintenance Responsibility. The Title 10 USC 2828 [g] gives the military the option of assigning the responsibility of maintenance (78:315). "Such a contract may provide for the contractor of the housing facilities to operate and maintain such housing facilities during the term of the lease" (78:315). Congress clarified this policy in a conference report dated December 22, 1987 (67:1005). This report directs the military to assume responsibility for maintenance after a one-year warranty period on the construction (67:1005; 81:1). The primary cause for this decision was to allow for a triple-net lease (80). Now, the military just competes a service contract for housing maintenance,

like it does on the majority of bases and posts (80). This lease arrangement eliminates the entrepreneur's risk of an increase in his costs (18; 23; 43; 80).

Enforcement of Standards. The standards of construction are established in the lease/contract. Failure by the entrepreneur to adhere to the terms of the lease/contract constitutes a breach of the contract (4:18-3). A breach of the contract gives the military grounds to terminate the contract for default (4:18-3). Under a triple-net lease arrangement, the construction period before the government's acceptance of the housing units is the major period where the entrepreneur incurs financial risk (80). Once the government accepts the facility, and the one-year warranty period passes, the contractor is free of any maintenance responsibility, except for latent defects (80). Under a triple-net lease, it is imperative that the military insure adherence to the terms of the contract/lease (80).

Since the housing units are not constructed on government land, the local building department has jurisdiction over construction standards and codes (53). The entrepreneur is often required by the lease to provide a developer, quality control plan (44:IV-6). This involves the entrepreneur employing an independent quality control inspector to insure sufficient inspection (44:IV-6). The model RFP also allows for the military to access and inspect the project at any time (44:IV-9).

One problem with military inspectors is that many are unfamiliar with local/national codes (23; 27; 37). Due to this problem, the military is prudent to retain an architectural and engineering (A&E) firm for construction management and inspection (23).

Impact on the DOD Budget. Private entrepreneurs should provide innovative housing designs and financing, shortened construction periods, and reduced construction costs for MFH (44:57). This approach should result in cost savings to the government. Cost effectiveness of all 801 housing projects is mandated by a requirement that they offer a savings of at least five percent over MCP, when the two approaches are compared in a lifecycle cost analysis for 20 years (13:59; 44:1005).

The biggest impact on the DOD budget comes in the military's ability to expense the housing units over the term of the contract (80; 86:1). The 801 housing approach avoids large upfront construction costs, reducing the military's financial outlays (10). To date, the Office of Management and Budget has not required the military to authorize or score the entire construction cost in the first contract year (80). The decision not to score the entire construction cost stems from an 801 housing project is not a purchase, but instead a lease (78:315; 80).

Applicability of State, County, and City Taxes. The DOD requires all future 801 housing projects to occur off government land (18; 23; 43; 80). Consequently, the

housing project is assessed all applicable taxes. Even if an 801 housing project uses government land, the housing is taxable. For a full discussion of this point see Chapter III (Outleasing).

Entrepreneurs need not worry about the tax rate being raised over the life of the project. Under the present triple-net lease approach, the military agrees to pay all tax increases "after the first two full years following final acceptance of the entire project" (44; 80).

Applicability of the Davis-Bacon Wage Act. The model RFP for 801 housing includes the Davis-Bacon Wage Act (44:IV-21). All interviews and review of the literature found that the Davis-Bacon Act applies on 801 housing (2:2-4; 15; 53; 80). The issue of prevailing wage rates has already been tested by the Wage Appeals Board. In the Matter of Military Housing, Fort Drum, New York, the Appeals Board held that the Davis-Bacon Act applied (64:2). The impact of this finding is that all construction workers constructing 801 housing must be paid the prevailing wage as determined by the Department of Labor. Using an average for the entire nation, the Davis-Bacon Act increases the cost of the housing by approximately 4.2 percent, over the same construction without it (8:122).

Minimal Requirements. The requirements for an 801 housing project are essentially the same as an outlease or a long-term facilities contract.

Before a RFP for an 801 housing project is started, a study must validate a housing deficit both on and off the base (78:315). A study may find a deficit even when the housing market is flooded with available homes (43). Often these available homes are out of the financial means of military members (43).

The decision to proceed with an 801 housing project is made after promising an economic analysis, using life-cycle costing, which compares the 801 approach against the MCP process (78:315).

Available private land for the housing project must next be found and an option secured (18). The intent of the land option is to offer all proposers the opportunity to use the same site (67:1005).

The support of Congress is mandated by the required twenty-one, calendar day notification of the appropriate committees (78:315). Early notification of Congress is suggested to avoid any problems (3:9; 60:8).

The most critical ingredient for a successful PSF project is interested entrepreneurs. They are only interested if the venture can provide an acceptable return on their investment (15:6-1). The triple net lease arrangement streamlines 801 housing for entrepreneurs and increases the availability of financing (18; 23; 43; 80). The private sector's interest in 801 housing is high as it is the most successful of the PSF initiatives (7; 40).

Who Must Approve. By law, a Service Secretary has the authority to enter into an 801 housing contract (78:315). The law also requires a twenty-one calendar day notification of the appropriate committees of Congress (78:315). The specific committees are the same as those used for the two previous PSF initiatives and are listed in Chapter III (Outleasing).

Experiences to Date

Of all the forms of PSF for military facilities, 801 housing is the most developed and utilized (22; 23; 40; 80). As of September 9, 1987, the armed services had contracts for 4,963 housing units at 14 different military installations (13:59; 44:Appen3). With much of the MCP budget taken for mission priorities, 801 housing is really the only way the military is getting any new MFH (44). The services are projecting to contract for an additional 11,000 housing units using the 801 approach (44:Appen4). Many 801 housing units have been occupied for several years. Experiences from these in-place 801 housing contracts allowed the military to learn more about dealing with entrepreneurs (80). A product of these learning experiences is the 801 Model Request for Proposal issued by the Office of the Assistant Secretary of Defense (P&L) Installations. Examination of this model RFP, along with review of past challenges provides insight into potential problems to be faced in other types of PSF ventures. The solution used for 801 housing may be applicable to other types of PSF projects.

Long-Term Financing Rate Fluctuations. A research question posed in this document dealt with the affect of the volatile long-term bond markets. More specifically, if an entrepreneur submits a proposal for a PSF project and before contract/lease award, the rates on long-term, financial instruments rise, the entrepreneurs cost of financing will increase (42; 61; 80). A large increase in long-term interest rates could change a profitable venture for an entrepreneur into a losing proposition (42; 47).

In the eventuality of an unfavorable rise in financing rates, after submittal of his proposal, an entrepreneur has a number of options. The first option is to provide a disclaimer in his proposal to the government. This disclaimer might state that if his costs of long-term financing rise above a certain threshold, before contract award, his proposal is withdrawn. This could prove confusing for contracting officers, who are not familiar with long-term financing. The most common approach is for the entrepreneur to put a time limitation on his proposal. Another option for the entrepreneur is to simply not perform if the government accepts his proposal and financing costs have risen too far. The entrepreneur may stall starting the project until financing rates drop (80). Yet, another option would be for the entrepreneur to secure a long-term guarantee from his lender, on the long-term financing. However, the longer the guarantee provided by a leading institution, the higher the rate and/or points for financing. A variance of this option

is for the entrepreneur to artificially increase his financing costs to cover an increase. Either way, higher financing rates mean higher prices for the government. Due to the options available to the entrepreneur and their impact on the military, the military needs to recognize the challenges of fluctuating interest rates between receipt of proposals and the award of a lease (80).

The probability of the entrepreneurs finance rates increasing exists for two basic reasons (47; 80). The first reason is the long time required for award of a PSF contract or lease (7; 80). While the government is seldom praised for its speed in awarding contracts, the time expected for PSF awards is even longer (40; 84). Every type of PSF project examined by this research required approval by a Service Secretary and a minimum 21-day notification of the Congressional Committees. Before the projects even get to the Service Secretary or Congress, each lease is scrutinized by commanders, lawyers, contracting officers, engineers, financial analysts and realty specialists at the service's headquarters and major commands. Complicating and delaying this process are many individuals, who do not have any experience with a PSF project (26:2; 40; 80). The second reason for an increase in an entrepreneur's financing costs/rates is the volatile long-term bond market. The prospects of any stability in this market are slim in light of Black Tuesday, October 19, 1987, and the coming Presidential election year (57). Since a slow contract/lease award and fluctuating

financing rates are a reality, the military must plan for them.

One approach which addresses fluctuating interest rates is found in the 801 Housing Model RFP. The following sections are taken from the RFP.

3. a. After evaluating proposals the Government will call for best and final offers. Such best and final offers will be treated as firm proposals in place of the proposals originally submitted. On the day the Contracting Officer requests best and final offers he will quote the previous day's yield of the most recent 10 year U.S. Treasury Bond. The yield quoted will be the previous day's closing yield for the most recent 10 year U.S. Treasury Bond, as reported in the Wall Street Journal dated the day best and final offers are requested. The Contracting Officer must award the Agreement to Lease within 45 days of the date of best and final offers are due or the successful proposer is not bound by the terms of his best and final offer [44:I-7].

b. Additionally, the successful proposer is not bound by the terms of his best and final offer is, on the day of award, the previous day's closing yield of the most recent 10 year U.S. Treasury Bond, as reported in the Wall Street Journal dated the day of award, is more than one half of one percent (50 basis points) higher than the yield quoted by the Contracting Officer on the day best and final proposals were requested. The successful proposer may at his option agree to accept and award made after the 45 days described in paragraph 3.a above, or when the yield described above has increased more than one half of one percent, however he must notify the Contracting Officer of his acceptance within 5 days of the date of award in writing and bonds and other documents are required to be submitted as scheduled in this RFP [44:I-8].

The above approach allows the entrepreneur to use his best rates, which translates into the best costs for the government. This way, the entrepreneur does not fear

financial ruin, as a 45-day lock on financing rates is typically the maximum attainable in the banking industry (10; 42; 47). The approach used for 801 housing leases can be used for outleases or long-term facilities contracts, as in both cases the entrepreneur utilizes long-term financing.

Failure to Perform. Many of the initial 801 housing leases were delayed by entrepreneurs who failed to start construction after award of the lease (22). Many factors explain their failure to perform. Examination of some of the factors which motivated entrepreneurs not to perform, along with the subsequent changes made by the government provides guidance for other types of PSF approaches.

Financing. The problem of fluctuating financing rates, mentioned earlier was a reality (80). The above clauses in the RFP now allow an entrepreneur to back out of a money losing venture (44:I-8). Previously, entrepreneurs delayed construction while shopping for lower financing rates or even playing the market, hoping for a drop in interest rates (80). The motivation for these actions is well understood. A one percent drop in the interest rate on a five million dollar, 20-year note results in a savings (profit) of \$22,975 a month for the entrepreneur. Should the rates increase, the entrepreneur just delays longer or defaults. All this time, the military's housing deficit is not being improved.

Proposal Bonds. Many of the problems mentioned earlier are solved through bonding (22; 80).

Under the Model RFP for 801 housing, every proposer is required to submit a proposal bond (44:I-4). The suggested bond amount is 10 percent of the annual rent for the first year or one million dollars, whichever is less (44:I-4). If the successful proposer fails to execute all contractual documents and post other bonding requirements within the time specified in the RFP, the contracting officer may terminate for default (44:I-4). The RFP addresses this termination for default with the following:

In the event the contract is terminated for default prior to delivery of a Lease Bond, the successful Proposer is liable for any cost, up to the amount of the Proposal Bond, of acquiring the work that exceeds the amount of its proposal. The proposal guarantee is available to offset the difference [44:I-4].

Construction Performance and Payment Bond.

To guarantee an entrepreneur's performance during the construction phase, the military requires a construction performance and payment bond (44:IV-8). The bond amount is for 100 percent of construction cost (44:IV-8). This bond guarantees the faithful performance of the construction and payment of all material and labor costs incurred by the contractor (9:162). In the event of a termination for default, the bonding agent becomes responsible for the project. These bonding requirements are now motivating entrepreneurs into timely performance (22; 80). Fluctuating financing rates were not the only problem in the early 801 housing projects.

Land Options. On the early RFPs for off-base housing, the military did not secure land options in advance of the RFP solicitation (80). In some instances, speculators purchased land or options on land in the prime areas for the housing projects (80). At a minimum, this drove the cost of the land and project up. To insure all entrepreneur's were given a fair chance and the land was acquired at a reasonable rate, Congress requested the Services purchase land options on the proposed land (67:1005). An added benefit of obtaining land options was the military's early involvement in the local community (43; 80).

Often the military's interface with local governments allowed the two to plan for water, sewage, and schools for the housing projects (43; 80). At Ft. Drum, the Army located their MFH in eight different towns within a 30-mile radius of the fort (18). The rationale was to minimize the impact on the local communities and environment (18). The need to involve the local community early on is critical (60:6).

Subject to Availability of Appropriations. On the first 801 housing projects, bankers had reservations about the "Subject to Annual Appropriations" clause in the government's lease (30:5; 42; 80). Title 10 USC 2828 [g] states:

A contract under this section shall include a provision that the obligation of the United States to make payments under the contract in any fiscal year is subject to the availability of appropriations for that purpose [78:315].

Many in the private sector viewed a lease with this clause as requiring performance by the entrepreneur for 20 years, while allowing the government to walk away without liability at year end (22). On the first 801 housing projects, many financiers refused to loan money to entrepreneurs (42). The financiers that did provide financing, charged as high as three percent (300 basis points) over the rate on government bonds with the same term (42). Major General George W. Miller III (USAF), a retired, Wall Street Investment Banker and special consultant to the Comptroller of the Air Force, believes a fair rate on these projects is .6 percent (60 basis points) over the yield on similar government bonds (42). To attain this rate more clarification by the military was needed on the affect of the "Subject to Availability of Appropriations" clause. Otherwise, the interest rates for these projects would remain high.

Much of the concern over the "Subject to Availability of Appropriations" clause is gone as a result of the explanations provided by the legal counsels for the services. A written explanation of the clause is provided by a Mr. Kishnir, an Associate General Counsel for the Under Secretary of the Navy for Real Estate and Housing in the Navy's Public/Private Ventures Guide (30:4).

He stated that the legislative history on the clause in both Title 10 USC 2828 [g] and Title 10 USC 2809, is silent on the reason for inclusion of the clause (30:4). Congress' reason for the clause was to make these PSF

programs consistent with Title 2 USC 651. Bills Providing New Spending Authority (30:4). This statute mandates that all new bills providing new spending authority passed by Congress will obtain funding from annual appropriations (30:4). The annual appropriation for leasing actions is a service's "Operation and Maintenance" (O&M) appropriation account (30:4). The funding in the O&M account is funded by Congress in a lump sum and seldom identifies specific programs (30:5). "This gives the Navy a certain degree of flexibility in administrating these funds so as the assure the Navy's legal obligations under the lease are met . . . " (30:5). Since the Services can reprogram funds within this account, the clause does not limit the term of the lease to one year (30:5). A deliberate act by Congress would be needed not to provide funds specifically for these leases (30:5). On no occasion has Congress directed the military not to honor its legal obligations, nor is this ever expected (4; 53). This challenge already faced by the 801 housing program, is equally applicable to long-term facilities contracts, as they are also subject to the "Subject to Annual Appropriations" provision (30:5).

Housing Maintenance. The largest area of controversy surrounding 801 housing is maintenance responsibility. In the beginning of the test, many in the military thought entrepreneurs would build a high quality house to minimize maintenance costs over the lifecycle of the project (80). Instead on about half of the projects, the entrepreneur

borrowed the maximum possible from the banks and built the cheapest house possible (80). The maximum amount an entrepreneur can borrow is based on the cash stream from the government's lease payments over 20 years (80). Next, these entrepreneurs took every opportunity to save money by minimizing maintenance expenses (80). Many involved in government service contracting have experienced contractors who intentionally perform just short of being terminated. This problem is further complicated by a contractor's attorney exploiting the ambiguities in these pilot programs (80). Should the government terminate the entrepreneur for default, they are stuck with a deteriorating housing project and upset bankers (80). The bankers are no longer receiving their monthly payments and are unable to recover from the entrepreneur, whose single purpose corporation declares bankruptcy (80). The bankers will next turn to the military to arrange a solution. Last and most important, a military commander will be extremely reluctant to move 300 families out of housing and into a housing market which has a deficit of suitable homes (80). The DOD solution to prevent the above scenario is a triple-net lease.

A triple-net lease arrangement has the added advantage of reducing the contractor's risk after acceptance of the housing units. "Risk reduction lowers the financing which in turn affects project cost" (30:5).

VI. Conclusions and Recommendations

Introduction

This study examines the concept of privatization of the government. Specifically, three forms of Private Sector Financing (PSF) of Military Facilities are examined indepth. The purpose of the research was to provide an introduction to the concept of PSF of military facilities. Another goal of the research was to answer questions which PSF project officers will be confronted with. Answers to these questions are presented in Appendix A and should serve as a fast reference guide for these three forms of PSF.

While the answers to the research questions are in Appendix A, the author also uses this chapter to present many conclusions and recommendations about PSF facility projects in general. These conclusions and recommendations were developed after an extensive review of the literature and after interviewing the individuals pioneering the development of PSF within the military services. Lastly, recommendations for future research are provided.

Conclusion

The need for new military facilities is growing faster than the appropriations of MCP construction funds by Congress. This has been the case even during the record high MCP appropriations of the Reagan Administration. As the Reagan Administration comes to an end, increased MCP

budgets appear more improbable. Both presidential candidates are campaigning on a platform of leveling or reducing the defense budget and increasing social programs. The fiscal responsibilities imposed by the Gramm-Rudman-Hollins Act will also pressure our elected officials to reduce federal spending.

The military procedure for building a facility, the MCP process, costs more and takes a longer amount of time than constructing the same facility in the private sector. The USAF, by law, is required to employ either the Army or Navy for construction of their facilities. In the majority of cases, these sister services hire an A&E firm to design the facilities. This design is reviewed and approved by no fewer than five levels of government bureaucracies. The hiring of an A&E firm is heavily regulated to insure an equal distribution of federal work among the nation's A&E firms. In contrast, the private sector owner selects the most qualified A&E firm and proceeds. Next, the Air Force facility design process uses layers of bureaucratic reviews and procurement rules to avoid mistakes and insure proper expenditure of public funds. The result is increased government facility costs. These bureaucratic reviews along with the congressional approval cycle add a minimum of two years to the military construction process. The Davis-Bacon Wage Act also requires construction workers on federal facilities to be paid the local prevailing wage. Using a national average, the cost of military construction is 4.2 percent

higher than the private sector due to the Davis-Bacon Wage Act.

The reality that government managers attain success differently from their counterparts in the private sector must be faced. In the private sector, the entrepreneur's reward is the amount of profit he generates. A successful entrepreneur pushes for the highest production at the lowest total costs. In contrast, national defense is intangible and cannot be evaluated as a dollar profit or loss. The government manager's compensation is based on his amount of responsibility in terms of money and people. For a government manager to achieve prestige and a larger salary, he must enlarge his budget and staff. Personal incentive to economize or seek efficiency is not generally rewarded in the public sector. Is a government manager rewarded by superiors for not expending his entire budget in a fiscal year? PSF can work to facilitate competition and motivate innovation.

The reality, that the private sector can usually provide a product or service at less cost than the public sector, is not new. Since 1955, under OMB Circular No. A-76, a drive has existed to privatize or contract out many operations of the federal government. The vast majority of these contracts took place in the DOD and resulted in significant cost savings and improved performance. President Reagan furthered this concept by establishing the President's Commission on Privatization, a bipartisan council

to study all federal programs and activities that could be turned over to the private sector. Additionally, many local governments have achieved success through privatization of public services. Most cases where privatization failed to produce a cost saving were a result of statements of work inadequately prepared by the government.

Recently, Congress enacted several test-bed laws allowing private sector financing of facilities for the military services. Congress is giving the military room to experiment with PSF to verify that substantial savings are possible. Within the DOD, knowledge about these PSF laws is extremely limited and few of these PSF projects (with the exception of 801 housing projects) have been completed successfully. PSF allows the military to contract with a private entrepreneur to finance, design, build, and maintain a facility either on or off government land. In return, the entrepreneur is compensated with some form of monthly payment which the military expenses from the O&M accounts.

The experiences from the 801 military family housing projects and the outlease of land to the Holiday Inn Corporation at Ft. Drum, New York, provide the following lessons-learned for future PSF contracts:

1. Entrepreneurs are interested in PSF if they stand to make a profit.
2. In preparing the RFP, the government can either establish the maximum cost for a service or the quality of the service, not both.

3. The military needs to minimize the number of controls and qualifications placed on the entrepreneur.
4. The greater the number of individuals involved in the PSF review process, the greater the confusion.
5. Most government employees involved with the contract review processes (including local base lawyers) are unfamiliar with the concept of PSF.
6. Many military construction inspectors are unfamiliar with local/national building codes.
7. Entrepreneurs will speculate on land in advance of contract award, driving the project cost up.
8. The government cannot expect something risk free! The financiers want guarantees that the debt on the facilities will be serviced.
9. Cost and risk are directly related. The greater the risk for the entrepreneur in providing a service to the government, the higher the cost for the government.
10. The government's termination liability in a PSF contract is the dollar amount which must be authorized by Congress in the first year of a PSF contract.
11. The government's RFP must address the potential of market financing rates fluctuating upward before award of the contract.
12. Entrepreneurs will delay starting a construction project in hopes of negotiating a lower financing rate with their bankers.
13. Congress is sensitive to criticism of unfair competition by Contractors operating on military lands.

PSF allows the military to acquire a needed service which requires construction of capital intensive facilities. These costly facilities can be expensed yearly on a "Pay as

you go" approach, keeping federal outlays down. PSF can reduce lifecycle costs and provide facilities rapidly.

The DOD will refine its PSF contracting skills only through negotiation (participation in the market place). Attempts to end run the MCP process with projects that do not provide a verifiable reduction in lifecycle costs will probably result in increased Congressional oversight.

Recommendations for Development of PSF in the USAF

1. Since little knowledge exists about PSF within the USAF, a Special Projects Office (SPO) should be created at the HQ/USAF level to advance the development and use of PSF within the USAF. The SPO needs to be self-sufficient and staffed with a minimum of the following professionals: contracting officers, engineers, financial analysts, lawyers, realty specialists, and services officers.

2. This SPO should be tasked to develop a policy for the bases and commands to identify potential PSF projects. This SPO should not be tasked with developing detailed regulations for the execution of the various PSF avenues. Rather, they should use the statutes just as they exist to allow the greatest flexibility in execution of PSF ventures. To little experience with the various avenues for PSF exists, and the SPO members would spend much of their time updating the regulations instead of refining PSF.

3. The SPO should be tasked with reviewing all PSF requests for proposals and PSF contracts/leases in the USAF

for the next several years. This function would provide the bases with quality control. Additionally, it would provide a centralized clearinghouse to insure mistakes made in the development of PSF are not repeated over and over. This type of control is required if the USAF wants Congress to renew test-bed legislations which allow PSF of military facilities.

4. Individuals bases should submit their proposed PSF projects through their commands to HQ/USAF for selection of those most viable for development. After selection, the SPO would assist the bases in development and execution of these projects. This approach should shorten the review process and provides the bases with qualified and experienced assistance.

5. A bi-annual conference of all the PSF offices within the Services should be held to share experiences and lessons-learned. This will increase the knowledge within the DOD and work to avoid mistakes in the military's development of PSF. As the development of PSF under a particular legislation matures, one DOD regulation should be prepared to allow for decentralized execution of that PSF approach.

6. General Patton's quote, "Never tell people how to do things. Tell them what to do and they will surprise you with their ingenuity," applies to PSF of military facilities. Contract for the final service and give the entrepreneur the maximum flexibility in providing it. The more restrictions imposed by the military the higher the cost.

7. Make a determination early in the project if the local building inspectors and/or the military construction inspectors are sufficient to inspect and accept the facility. If any doubt exists, the military should contract with the private sector for construction inspection services.

8. The government's termination liability should be limited on PSF projects, while at the same time providing assurances to the financiers that the debt on the facilities will be serviced. To accomplish this, the government's termination for convenience clause should be eliminated and the termination for default clause should be modified to allow for termination of only the operations and/or maintenance after the facility is accepted by the military.

9. The government's RFP should address the situation of finance rate changes before award of the contract/lease. The time between the government's receipt of proposals and contract/lease award may be long. This time period along with the dynamic nature of the financial markets can affect an entrepreneur's costs.

10. The government should be protected from an entrepreneur's lack of performance through bonding.

11. If government land is not going to be used in a PSF venture, a land option should be secured on the private land prior to solicitation of the RFP.

12. Cultivate local and Congressional support for a PSF project!

Recommendations for Further Research

Future research in this should be directed at expanding the military's knowledge base on PSF of military facilities. This study has two recommendations for future research.

The first recommendation is to examine other enabling legislations pertaining to PSF military facilities. This research would serve to educate the military in other options of potentially reducing facility lifecycle costs. The following U.S. Statutes are provided to assist future researchers:

1. Title 10 USC 2394. Contracts for energy or fuel for military installations
2. Title 10 USC 2483. Sale of electricity from alternate energy and cogeneration production facilities
3. Title 10 USC 2675. Leases: Foreign Countries
4. Title 10 USC 2821. Military Housing Rental Guarantee Program
5. Title 40 USC 490. Operation of Buildings and Related Activities by Administrator
6. Title 42 USC 8287. Shared Energy Savings

These legislations are just a starting point, as Congress may eliminate or add to the above list.

A second recommendation is to update this research and verify if the answers to research questions and conclusions provided here, hold to be valid. In the coming years, this research will be tested through several PSF facility projects, many of which may end in federal court decisions.

Within the USAF alone, the hotel projects at Wright-Patterson AFB and Nellis AFB and the central office complex, ASD 2000 should provide a starting point for researchers. A final recommendation for future research would be to interview the staff assistants assigned to the four Congressional Subcommittees, which by law review all PSF facility projects.

This research is just a starting point, as the area of PSF is in its early development and this topic will evolve more in the years to come.

Appendix A: Summarization of Issues

TABLE 1
Summarization of Issues Facing PSF Ventures

| | Outleasing | Long-Term Facilities Contracts | Build/Lease of Military Family Housing |
|---------------------------|--|--|--|
| Enabling Legislation | Title 10 USC 2667 Title 10 USC 2662 | Title 10 USC 2809 Legislation expires 30 Sept 1989 | Title 10 USC 2828 [g] Legislation expires 30 Sept 1989 |
| Approval Authority | Military Service Secretary after 30 days Notification of Con- gressional Committees | Military Service Secretary after 21 days Notification of Con- gressional Committees | Military Service Secretary after 21 days Notification of Con- gressional Committees |
| Facilities Permitted | Unlimited | Child care services, Potable and waste/water treatment services, depot supply activities, troop housing, transient housing, hospital or med- ical facilities, logistic and administrative service | Military family housing units with additional provisions for child care centers, civic center buildings, tot lots or other structures to support the MFH complex |
| Term of Contract/Lease | No statutory limit | Statute limits to 20 years | Statute limits to 20 years |

TABLE 1 (continued)

| Issue | Outleasing | Long-Term Facilities Contracts | | Build/Lease of Military Family Housing |
|---|---|-----------------------------------|--|--|
| | | Yes, for any term | Yes, as a services contract | |
| Renewable | | Yes, for any term | Yes, as a services contract | Yes, on a yearly basis |
| Location of Facility | On government land | | On or off of government land | Statute allows for either on or off government land, DOD policy is all will be off <u>government land</u> |
| Contractor's Rental Rate for Government | Rental rate established in lease, a one dollar nominal charge for entire term is allowed | | If on government land, the rental rate is established in lease, a one dollar nominal charge for entire term is allowed | If DOD allows on-base development, the rental rate is established in lease, a one dollar nominal charge for entire term is allowed |
| | | | If off-base, entrepreneur purchases land outright. Good idea for government to acquire a land option | If off-base, entrepreneur purchases land outright at price established by government land option |
| Applicability of Davis-Bacon Wage Act | No, but check for State's prevailing wage law | Yes | Yes | Yes |

TABLE 1 (continued)

| Issue | Outleasing | Long-Term Facilities Contracts | Build/Lease of Military Family Housing |
|-------------------------------|--|--|--|
| Ownership at End of Lease | Land - military <u>Facilities - estab-</u> <u>lished in lease, if</u> military to acquire Con- gressional notification will be needed at time of acquisition | Land (on-base) - military <u>Land (off-base) - entre-</u> <u>preneur</u> Facilities (on-base) - established in lease, if military to acquire Con- gressional notification will be needed at time of acquisition <u>Facilities (off-base) -</u> <u>entrepreneur - Note:</u> with Congressional approv- al and funding military can purchase both land and facilities outright | Land (on-base) - military <u>Land (off-base) - entre-</u> <u>preneur</u> Facilities (on-base) - established in lease, if military to acquire Con- gressional notification will be needed at time of acquisition <u>Facilities (off-base) -</u> <u>entrepreneur - Note:</u> with Congressional approv- al and funding military can purchase both land and facilities outright |
| Maintenance Responsibility | <u>Entrepreneur</u> | Entrepreneur - government can terminate for default service portion (including maintenance) and assume duties with military or another contractor | Military - DOD policy is for triple net lease with with maintenance performed under separate contract |

TABLE 1 (continued)

| Issue | Outleasing | Long-Term Facilities Contracts | Build/Lease of Military Family Housing |
|---|---|--|---|
| Applicability of State, County, and City Taxes | Yes, statute allows for renegotiation of lease if new taxes are assessed after lease is signed | Yes, recommend lease/ contract allow all tax increases be paid by the military | Yes, under triple net lease, all tax increases after the second year are paid by the military |
| Construction Standards | Local/national building codes apply, facility design and construction materials established in entrepreneur's proposal | If off-base, local/ national building codes apply; on-base, the codes, design, and construction materials are determined by military project manager | Statute states minimum DOD standards; this has been applied to mean minimum local/national building codes plus design and specifications as estab- lished in entrepreneur's proposal |
| Construction Inspection | Local government build- ing inspectors, and the following as allowed in lease: contractor quality control, mili- tary inspectors (local A&E firm retained by military) | Local government building inspectors, and the following as allowed in lease/contract: contractor quality con- trol, military inspectors (local A&E firm retained by military) | Local government building inspectors, and the following as allowed in lease/contract: contractor quality con- trol, military inspectors (local A&E firm retained by military) |

TABLE 1 (continued)

| Issue | Outleasing | Long-Term Facilities Contracts | Build/Lease of Military Family Housing |
|---|--|---|--|
| Failure of Construction to Comply with Building Codes | Local government build- ing officials can halt construction; military can halt construction | Local government building officials can halt construction; military can halt construction | Local government building officials can halt construction; military can halt construction |
| Penalty for Failure of Construction to Comply with Proposed by Entrepreneur in Proposal | Contractor in breach of lease and military does not utilize facility; contractor has no cashflow to pay expenses | Contractor in breach of of contract; refusal by military to accept facil- ity; service portion of cannot commence; recommend lease bonds and construc- tion bonds | Contractor in breach of of lease; refusal by mili- tary to accept housing; lease bonds and construction bonds are held by military |
| Financial Risk | Entrepreneur assumes risk, <u>no</u> allowance for government guarantee with appropriated funds | Government assumes risk; entrepreneur's service portion of contract can be terminated for default; but, payment on facility by government continues | <u>Government assumes all risk after acceptance of MFH;</u> triple net lease arrange- ment insures this for the entrepreneur |

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Abstract

The purpose of this study was to introduce the concept of Private Sector Financing (PSF) of military facilities instead of acquiring facilities via the Military Construction Process. Another goal of the research was to provide project officers with answers to questions which will arise in the development of a PSF project. Specifically, this study examined three avenues of PSF presently authorized by Congressional law. These answers are presented in a quick reference guide, which was developed after an indepth analysis of the U.S. Statutes and interviews of those involved with PSF in the Department of Defense. Additionally, this research presents conclusions from military PSF projects to date and recommendations for future projects.

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